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No.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA
AND THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA,
Petitioners,

VS.

TENNECO OIL COMPANY, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Whether under section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b), as implemented by this Court in the *Phillips* case (*Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954)) and in the *Rayne Field* case (*United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965)), the Federal Energy Regulatory Commission has jurisdiction to prevent producers from collecting enormous amounts far in excess of applicable ceiling prices for vast, proven natural gas reserves which they dedicated to major interstate pipeline suppliers of California and other western states through lease-sale transactions that were the economic equivalent of producer sales contracts and that compelled the pipelines to engage in extensive developmental drilling immediately upon the closing of the lease-sale agreements.

LIST OF PARTIES

Public Agencies:

Federal

Federal Energy Regulatory Commission

State

People of the State of California
Public Utilities Commission of the State of California
Idaho Public Utilities Commission
Public Service Commission of Nevada
Public Utilities Commissioner of Oregon
Washington Utility & Transportation Commission
Public Service Commission of Wyoming

City

City of Ellensburg, Washington

Interstate Natural Gas Pipeline Companies:

El Paso Natural Gas Company
Northwest Pipeline Corporation

Distribution Companies:

Cascade Natural Gas Corporation
Colorado Interstate Gas Company
Intermountain Gas Company
Mountain Fuel Supply Company
Northwest Natural Gas Company
Pacific Gas and Electric Company
Rocky Mountain Natural Gas Company
San Diego Gas & Electric Company
Southern California Edison Company
Southern California Gas Company
Southern Union Company
Southwest Gas Corporation
Washington Natural Gas Company
Washington Water & Power Company

Producers:

El Paso's System	Party
GLA 47	Tenneco Oil Company Conoco, Inc.
GLA 51	Mapco, Inc. Hopi Oil Company
GLA 52	Tenneco Oil Company Conoco, Inc.
GLA 60	Tenneco Oil Company Conoco, Inc. Charles Colwill Anne Home Emerson, Trustee Anna Lou Home Jean E. Keyser Cassandra Keyser Teresa Home Barron Kidd Helen Ulmer van Atta
GLA 61	Sun Oil Company (Delaware)
GLA 62	FHN, Ltd.
GLA 63	Atlantic Richfield Company
GLA 66	W. Watson LaForce, Jr. Henry P. Isham, Jr. Estate Robert T. Isham Josephine C. Jacobson J. Roberts Jones Nancy LaForce Keyes Frederic P. G. Lattner, Trustee, U/T Martha M. Lattner, Settlor Suzanne LaForce Baber James C. Bard Douglas N. Bard Ralph A. Bard, Jr. Roy E. Bard, Jr. G. Brainard, Jr. Trust Continental Illinois National Bank and Trust Company, Trustee Trust #23935

El Paso's System	Party
	Continental Illinois National Bank and Trust Company, Trustee Trust #23949
	Eleanor Isham Dunne
	Charles W. Farnham, Jr.
	Robert B. Farnham
	Walter B. Farnham
	Elizabeth B. Farrington
	Minnie A. Fitting
	R. U. Fitting, Jr. Estate
	Robert D. Fitting
	Nancy H. Gerson
	John R. Grimes
	Ruth N. Halls
	Cortland T. Hill
	Elsie F. Hill
	Louis W. Hill, Jr.
	Albert L. Hopkins, Jr.
	George S. Isham
	R. S. MacDonald, A. MacDonald and Northern Trust Co., Trustees U/W of N.S. MacDonald, Deceased
	Mary F. Love
	William J. McDermott, Trustee
	Nora R. Ranney
	Catherine H. Ruml
	Edward L. Ryerson, Jr.
	Sabine Royalty Corporation
	Shaw, Isham & Company
	John I. Shaw, et al., Trustee
	James Simpson, Jr. Trust
	William E. Simpson Trust
	Sydney Stein, Jr.
	Northern Trust Co., Trustee, U/W of John Stuart Robert Douglas Stuart Estate
	William P. Sutter
	Michael Simpson Trust
	Patricia Simpson Trust
	Katharine I. White

El Paso's System	Party
	Kay B. Gundlach
	Frederick F. Webster Trust
	Mary S. Zick
	David Waller Dangler
GLA 72	Mapco, Inc.
	Hopi Oil Company
GLA 76	Union Oil Company of California
	First National Bank of Ft. Worth, Trustee for Eula May Johnston
	James J. Johnston
	V. A. Johnston Family Trust
	Jones Company
	Wm. C. McMahan Estate
	Homer R. Stasney & Sons Company
	Rogers-Gibbard Trust
GLA 77	Robert Beamon
	Robert Beamon, Trustee
	Pattie Ann Beamon Lundell
	Thomas L. Hall, Trustee
GLA 78	American Petrofina Company
	Tenneco Oil Company
	Conoco, Inc.
GLA 86, 101, 127	Mapco, Inc.
	Hopi Oil Company
GLA 106	Morris and Flora Mizel
GLA 122	Producing Royalties, Inc.
	Harold S. Long
	Dixie M. McLane, Trust
	Mrs. Judy St. John Taylor
	John S. White
GLA 125	American Petrofina Company
	Anderson Construction Company, Inc.
	Benson-Montin-Greer Drilling Corp.
	Tom Bolack
	Oliver Benson
	Albert R. Greer
	Mary Eddy Jones

El Paso's System	Party
	Edna Fern Benson
	Walter Benson
	Charlene K. Greer
	Mary E. Jones and The First National Bank & Trust Company of Oklahoma City, Trustees U/W of F. Jones
	Late Oil Company
	A. C. Montin, Jr.
	William V. Montin
	Oklahoma and Northwestern Company
GLA 129	Delta Drilling Company
	Trustees of the DeGolyer Foundation
	Mrs. Nell V. DeGolyer
GLA 139	Producing Royalties, Inc.
	James A. and Hazel H. Borland
	R. Lewis Chandler Trust
	Marcy C. Fannin
	Charles E. Graham, Jr.
	Newell R. Hays
	Dixie M. McLane Grandchildren's Trust
	Critchell Parsons
	Judy St. John Taylor
GLA 152, 160, 231	J. Glenn Turner
	Sue Reeder Turner Trust
	William G. Webb
GLA 153	Gretchen A. Gartner
	Helen L. Harvey
GLA 157	Mapco, Inc.
	Barbara Ann Bruss
	O. J. Lilly
	Barbara Irene McConnell
GLA 172	Crown Central Petroleum Corporation
GLA 195	William G. Webb
GLA 196	J. Glenn Turner
	Sue Reeder Turner Trust
	William G. Webb
	Benson-Montin-Greer Drilling Corp.

El Paso's System	Party
	Barbara Ann Bruss
	Charles Albert Greer
	La Plata Gathering System, Inc.
	O. J. Lilly
	Huerfanito Gas Co., et al., PP
	Barbara Irene McConnell
	Mary R. Boecking and H. E. Boecking, Jr., Trustees
	Jacqulyn M. Williams
GLA 197	Huerfanito Drilling Company, Inc.
GLA 198, 248	J. Glenn Turner
	Sue Reeder Turner Trust
	William G. Webb
	Frank A. Schultz
GLA 249	Benson-Montin-Greer Drilling Corp.
	Barbara Ann Bruss
	Charles Albert Greer
	La Plata Gathering System, Inc.
	O. J. Lilly
	Barbara Irene McConnell
	Mary R. Boecking and H. E. Boecking, Jr., Trustees, U/T of Mary M. Strachley
	J. Glenn Turner
	Sue Reeder Turner Trust
	Jacqulyn M. Williams
GLA 348	Union Oil Company of California
	Jones Company
	W. C. McMahan
	H. R. Stasney & Sons Company
GLA 349	Union Oil Company of California
GLA 350, 351	Robert Beamon
	Robert Beamon, Trustee
	Thomas L. Hail, Trustee
	Pattie Ann Beamon Lundell

Northwest's System	Party
PLA 2	Atlantic Richfield Company
PLA 3	Getty Oil Company
PLA 4	Grace M. Brown
	Catherine B. McElvain, Inc. and as Executive of Estate of T.H. McElvain, Deceased
	T.H. McElvain Oil and Gas Properties
	James E. McElvain, Executor of Estate of Carl R. McElvain
	J. Wm. McElvain
	Estate of F.B. Miller
	Mabelle McElvain Miller
	Mrs. Ruth M. Vaughn
PLA 5	Phillips Petroleum Company
PLA 6	Amoco Production Company
	J. Ralph Ellis, Jr.
	Jones Felvey, II
	First National Bank in Dallas for the Acct. of J. Ralph Ellis, Jr.
	McCulloch Oil Corporation
	Mountain States Natural Gas Corp.
	John D. Mugg, Jr.
	Jack B. Ryan
	Texas Oil & Gas Corp.
	U. V. Industries
PLAs 7, 9, 10, 11	Amoco Production Company
PLA 8	J. Ralph Ellis, Jr.
	Jones Felvey, II
	First National Bank in Dallas for the Acct. of J. Ralph Ellis, Jr.
	H. M. Meredity Trustee and First National Bank of J. Ralph Ellis, Jr.
	Mountain States Natural Gas Corp.
	John D. Mugg, Jr.
	Amoco Production Company
	Jack B. Ryan
	Texas Oil & Gas Corp.
PLA 13	Mobil Oil Corporation
PLA 14	Champlin Petroleum Co.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners the People of the State of California and the Public Utilities Commission of the State of California (California) respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered on July 5, 1983.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 708 F.2d 1011 (1983) and is printed at Appendix 1a-19a.[1] The Court of Appeals reversed a decision of the Federal Energy Regulatory Commission (FERC) and affirmed a decision of a federal district court. The presiding Administrative Law Judge's (ALJ) Initial Decision on Jurisdictional Status of Lease-Sale Agreements, *El Paso Natural Gas Company,* Docket No. CP74-314, *et al.,* is reported at 12 F.E.R.C. ¶ 63,037 (1979), and is printed at App. 33a-120a. The FERC's Order Affirming Initial Decision and Initiating Further Hearing, *El Paso Natural Gas Company,* Docket No. CP74-314, *et al.,* is reported at 12 F.E.R.C. ¶ 61,296 (1980) and is printed at App. 21a-31a. The FERC's Order Denying Applications for Rehearing is reported at 13 F.E.R.C. ¶ 61,239 (1980) and is printed at App. 153a-54a. The decision of the district court, *El Paso Natural Gas Co. v. Sun Oil Co.,* is reported at 426 F.Supp. 963 (W.D. Tex. 1977) and is printed at App. 121a-36a. The Court of Appeals concluded in 1978 that it should not decide the appeal from the district court until it had the benefit of the FERC decision. This opinion and an order clarifying it are printed at App. 137a-44a. The opinion, *Tenneco Oil Co. v. FERC,* is reported at 580 F.2d 722 (5th Cir. 1978).

STATEMENT OF GROUNDS ON WHICH JURISDICTION IS INVOKED

1. The Court of Appeals for the Fifth Circuit concluded that the San Juan lease-sale transfers involved in this proceeding were not sales for resale under § 1(b) of

[1] California has filed a separate Appendix that contains all opinions issued in this matter and the judgment below. Hereinafter, the Appendix will be referred to as "App."

the Natural Gas Act, 15 U.S.C. § 717(b). In so ruling, the Fifth Circuit reversed a FERC determination that the transfers were in economic effect sales under section 1(b) and affirmed an earlier federal district court decision that the transfers were not sales under section 1(b). The FERC had jurisdiction pursuant to §§ 4, 5, 8, 14 and 16 of the Natural Gas Act, 15 U.S.C. §§ 717c, d, f, g, m and o. The district court had jurisdiction pursuant to 28 U.S.C. § 1331 and § 22 of the Natural Gas Act, 15 U.S. § 717u. The FERC, however, was not a party to the district court proceeding; the district court declined to refer the jurisdictional issue in this case to the FERC under the doctrine of primary jurisdiction.

2. The Court of Appeals entered judgments on July 5, 1983. App. 145a, 147a, 149a. The Court of Appeals denied rehearing on December 2, 1983. App. 151a-52a.

3. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and § 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTORY PROVISION INVOLVED

Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b) provides:

> The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

STATEMENT OF THE CASE

1. Statement of Facts

In 1938, Congress enacted the Natural Gas Act, 15 U.S.C. § 717 *et seq.*, to protect consumers against "exploitation at the hands of natural gas companies." *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 685 (1954). The present case involves natural gas producers who attempted to circumvent the Natural Gas Act in the 1950s and thereafter, while taking advantage of the tremendous increase in the need for natural gas in California.

Beginning in the late 1940s, demand for natural gas in California grew at a rapid pace to fuel the state's explosive growth in population and industrial development. *E.g.*, *San Juan Pipe Line Co.*, 9 F.P.C. 170, 178-79 (1950). California's main out-of-state source of natural gas was then the Permian Basin of west Texas. Since the San Juan Basin of New Mexico is closer to California than the Permian Basin, it was a much more ideal source of new supply. App. 44a-45a.

As of 1950, the San Juan Basin was already known as "one of the major fields of 'gas in place' in North America." R. 9936;[2] App. 106a. The two Mesaverde sandstones in the Basin were known to contain gas in great commercial quantities. App. 52a. In 1950, the Federal Power Commission (FPC), predecessor of FERC, authorized El Paso Natural Gas Company (El Paso), an interstate pipeline company and the largest supplier of natural gas for end

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[2] R. refers to the official FERC record.

use in California, to move gas from the San Juan Basin to California. App. 51a.

To meet the accelerated demand, El Paso sought large, additional supplies of natural gas for California in the San Juan Basin. In so doing, El Paso was compelled to deal with Delhi Oil Company (Delhi),[3] an oil and gas company which had assembled large acreage and vast, proven natural gas reserves in the San Juan Basin during the period 1950-1951. App. 57a.

Around this time, drilling activity was intense in the San Juan Basin, particularly in the Mesaverde sandstones. As of the fall of 1951, Delhi had fifteen (15) Mesaverde wells, App. 66a, and much of Delhi's acreage was surrounded by numerous Mesaverde wells. R. 9972. As of year-end 1951, there were 103 Mesaverde wells in the Basin. R. 9925.

By November 1951, Delhi had determined that 250 Mesaverde wells were needed to develop fully Delhi's undedicated[4] Mesaverde reserves, that these wells could be drilled within four (4) years, and that they could produce great quantities of natural gas. R. 9692.[5] Recognizing Delhi's

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[3]Tenneco Oil Co. and Conoco, Inc. are successors-in-interest of Delhi.

[4]"Undedicated" is a term of art meaning that the reserves were not committed or dedicated by prior contracts.

[5]Delhi estimated that these wells could produce 700 thousand cubic feet (Mcf) per well per day in early years, and that 1.063 trillion cubic feet (Tcf) could be produced at the rate of 14.9 billion cubic feet (Bcf) in year one (58 wells), 39.3 Bcf in year two (154 wells), 60.8 Bcf in year three (238 wells), and 63.9 Bcf in year four (250 wells) with production moderately declining thereafter. R. 9692.

Mesaverde reserves as the prime candidate to fulfill California's growing needs, El Paso began negotiating to purchase them from Delhi. App. 57a.

Delhi knew from prior experience, that if it sold the the reserves to El Paso under a conventional producer-pipeline contract, then it risked federal price regulation under the Natural Gas Act. App. 44a-51a, 59a-60a. So, Delhi devised a lease-sale contract that was the economic equivalent of the conventional sale and sold the gas pursuant to the gas lease-sale agreement (GLA).[6] See App. 25a.

Under the first transaction, known as GLA-47, Delhi assigned the leases, including the existing wells, to El Paso in return for El Paso's agreement to pay Delhi a "special overriding royalty" which started at 5.5¢ per Mcf with Delhi having the right in later years to obtain periodic redeterminations based on market value.[7] El Paso also paid Delhi for the existing wells and bore all remaining development costs and operating expenses.

Notwithstanding El Paso's responsibility for further developing these reserves, Delhi retained control over the development by imposing in GLA-47 a rapid development

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[6]The Fifth Circuit's opinion, below, did not dispute that these lease-sale agreements were the economic equivalent of conventional sales. App. 12a.

[7]Delhi's special overriding royalty was based upon its net interest (about 70%) in the gas reserves. R.4090, 4092-93. The original lessor had a conventional royalty interest and subsequent parties in the chain of title (before Delhi acquired the leases) reserved fractional overriding royalties in the production of the gas. Delhi's special overriding royalty was paid on the entire balance of the production (about 70%) after deducting the other royalty interests.

program on El Paso, which required El Paso to promptly develop the reserves, thus assuring Delhi of a large income stream as soon as possible.[8] App. 58a-59a.

Pursuant to its obligation, El Paso immediately began to develop these reserves and substantial supplies of gas were delivered into its interstate system.[9] Indeed, based largely on the GLA-47 reserves, in June, 1952, the FPC removed a limitation on deliveries from the San Juan area so that El Paso could deliver to California customers an additional 120,000 Mcf per day from sources in the San Juan Basin. *El Paso Natural Gas Co.*, 11 F.P.C. 1071, 1073-74 (1952).

GLA-47 became widely known in the Basin as the "Delhi" deal. App. 61a. Seeking to avoid federal regulation, other producers in the Basin insisted on similar terms as the Delhi deal and eventually sold their gas to El Paso under gas lease-sale agreements (GLAs). App. 61a-65a.

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[8]El Paso agreed to drill one Mesaverde well on each 320-acre undrilled location within five years or to release the drilling unit to Delhi. R.4099. It required no more than a month to spud and complete a Mesaverde well. R.5378 ("one well per month per rig"). El Paso agreed "as soon as possible" to tie the GLA-47 wells existing at closing and wells to be drilled pursuant to the development program into its gathering system. R.4101. This obligation continued until the reserves were producing at the rate of 100,000 Mcf per day. R.4101. Delhi required El Paso to keep six rigs in operation until such time as GLA-47 was producing 100,000 Mcf per day. R.4101-02. Because Delhi had rigs available, Delhi obligated El Paso to select Delhi as drilling contractor to drill 80 Mesaverde wells for El Paso's account. R.4099-100.

[9]GLA-47 was closed on March 1, 1952. El Paso extended its gathering system to take deliveries from three of Delhi's Mesaverde wells by the end of March. R.5241; R.5245; R.5147; App. 60a. By year-end 1952, 28 GLA-47 Mesaverde wells were delivering into El Paso's system; by year-end 1953, 104 GLA-47 Mesaverde wells were delivering into El Paso's system. R.5241-46.

Pacific Northwest Pipeline Corporation (PNW), predecessor to Northwest Pipeline Corporation (NWP), came into the Basin in 1952. App. 74a. To be competitive, it offered producers the option of selling their gas under a conventional sales contract or under a "Delhi" deal. App. 74a-75a. Not surprisingly, PNW acquired virtually all of its San Juan reserves under the lease-sale form. These are known as the "PLAs." PNW's pipeline from the Basin to the states in the Pacific Northwest was founded on PLA reserves. App. 74a-80a.

In the 1950s and 1960s, the special overriding royalty paid producers escalated to 10¢ per Mcf. Until 1973, the producers did not seek to redetermine their special overriding royalty at market value. Then, Sun Oil Company (Sun), one of the producers, demanded an increase to market value. App. 40a. When El Paso rejected its demand, Sun invoked the arbitration clause in its GLA. A Board of Arbitrators in 1973 awarded Sun a special overriding royalty of 40¢ per Mcf. App. 40a. This massive increase in the price of natural gas had a snowballing effect as other producers sought to take advantage of the Sun award by claiming that they were entitled to favored nations treatment pursuant to their GLAs or sought an increase through arbitration themselves. App. 40a-44a.

2. Proceedings Below

In 1973, El Paso brought suit in a federal district court claiming that the GLAs were in economic effect sales of gas, and hence jurisdictional under this Court's opinion in *Rayne Field (United Gas Improvement Co. v Continental Oil Co.*, 381 U.S. 392 (1965)). El Paso sought to enjoin the arbitrations being pursued by the producers and requested

that the court refer the jurisdictional issue to the FPC under the doctrine of primary jurisdiction. California intervened in support of El Paso. Northwest Pipeline Corporation (NWP) intervened in early 1974. In 1974, El Paso filed a complaint with the FPC and in that complaint requested that the FPC determine the jurisdictional issue. California again intervened. NWP filed a similar complaint.

In 1974, El Paso undertook to settle its contract dispute with the producers. California did not participate in these negotiations and had not even been informed of them until after the agreements (known as the "1974 Settlement Agreements") had been reached. Pursuant to the 1974 Settlement Agreements, El Paso agreed to pay the producers, beginning June 1, 1974, a special overriding royalty of 40¢ per Mcf and further agreed to redetermine the level of this payment each June 1, with the payment per Mcf to equal the *highest* rate of general applicability prescribed by the FPC or successor agency less 7 cents per Mcf. In these agreements, the parties recognized that El Paso would continue to litigate the jurisdictional issue and were therefore aware that in the event El Paso prevailed on the jurisdictional issue, the amount paid, beyond what the FPC determined to be just and reasonable, would be subject to refund. Until October 1, 1983, El Paso has at all times included the special overriding royalties and its full costs of production as components of its cost of service and collected from its customers, and ultimately California ratepayers, the amount needed to pay these costs. However, after this Court's decision in *Public Service Commission of New York v. Mid-Louisiana Gas. Co.*, ...U.S....., 103 S.Ct. 3024, 77 L. Ed. 2d 668 (June 28, 1983) limited El Paso to the maximum lawful prices under the Natural Gas Policy

Act of 1978 (NGPA), 15 U.S.C. §§ 3301, *et seq.*, El Paso has now deemed the GLA wells to be unprofitable and has taken action to reassign the wells to the producers pursuant to a provision in the GLA agreements.[10]

Paying the bulk of these special overriding royalties, California has since 1973 sought a final ruling that the GLA transactions were in economic effect sales under the Natural Gas Act and therefore subject to FPC (now FERC) regulation.

In the action brought by El Paso in the federal district court, the court never acted on the motion that the court refer the jurisdictional issue to the FPC under the primary jurisdiction doctrine. Instead, the court in 1977 ruled that the lease-sale transfers were not jurisdictional under *Rayne Field* and its progeny. App. 121a-36a. Following the district court's decision, the FPC initiated an investigation on El Paso's complaint. In 1979, FERC Administrative Law Judge Benkin, in a comprehensive opinion, determined that the lease-sale transfers were jurisdictional under *Rayne Field* and its progeny. App. 33a-120a. In 1980 the FERC affirmed the opinion (App. 21a-31a) and denied rehearing. App. 153a-54a.

While the district court's and the FERC's decisions were being appealed, the FERC instituted remedy proceedings to determine the proper rates for the GLA and PLA gas and the amount of refunds due El Paso and NWP, which would ultimately be passed on to the ratepayers. App. 153-54a.

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[10]The producers are contesting this reassignment in state court litigation presently underway in the District Court, 11th Judicial District, Harris County, Texas.

Because the 1974 Settlement Agreements had tied the level of special overriding royalty payments to the highest regulated rate of general applicability and such rates escalated rapidly, especially with the advent of NGPA pricing in 1979, the amounts paid as special overriding royalties by El Paso and NWP (and ultimately the ratepayers) increased dramatically over the years since 1974. Consequently, California (as well as FERC staff) estimate that from 1974 through 1982 ratepayers on El Paso's system alone have been overcharged in excess of $1 billion, including interest on the overcharges, and are entitled to refunds in that amount.[11] After over two (2) years of hearings and discovery, the FERC remedy proceeding trial was set for September, 1983.

On July 5, 1983, the Court of Appeals for the Fifth Circuit, reviewing both the District Court's and the FERC's decisions, ruled that the lease-sale transfers of natural gas were not jurisdictional.[12] App. 1a-19a. The Court agreed with the FERC that the San Juan lease-sale transactions were in economic effect similar to that of a

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[11]California bases its estimate on valuing the gas at the applicable Natural Gas Act and NGPA rates, deducting El Paso's cost of production and paying to the GLA producers those values less cost. For example, since 1979, El Paso has paid these producers at the NGPA § 102 rate for new gas (15 U.S.C. § 3312) less 7 cents when much of the gas would be considered NGPA § 104 flowing gas (15 U.S.C. § 3314) if the GLAs were jurisdictional and properly regulated. The significance of this discrepancy is readily apparent when considering that as of June 1, 1982, the § 102 new gas rate was $3.44/MMBtu and the § 104 flowing gas rate was $.52 MMBtu. Of course, the producers do not agree with this proposal and have offered their own proposal in the FERC remedy proceedings.

[12]The FERC remedy proceeding has consequently been suspended.

conventional sale. App. 12a-14a. The Court also agreed with the FERC that the gas volumes were proven when the GLA/PLA agreements were made. App. 15a. The Court did not challenge the FERC's finding that the development wells drilled shortly after transfer enabled the pipelines to take the gas in great quantities to supply western markets, especially California. The Court ruled, however, that the lease-sale transfers were not jurisdictional because the development drilling was to be done by the pipeline after closing, rather than by the producers before closing. App. 15a-16a.

In so ruling, the Fifth Circuit stated the "Commission's downplaying of the development issue may well foreshadow the next stage in the evolution of the law" (App. 15a) but stated that it was precluded by this Court's opinion in *Rayne Field* from holding that lease-sale transfers were jurisdictional in the absence of substantial development drilling. App. 15a-16a. Under the Fifth Circuit's holding, the FERC's jurisdiction over the economic equivalent of a producer wellhead sale is made to turn on the extent of development (as opposed to exploratory) drilling, even though the producer controls the timing of development in the lease-sale agreement. As a consequence, an important class of wholesales of natural gas is exempt from FERC regulation under the Natural Gas Act.

On December 2, 1983, the Court of Appeals denied all petitions for rehearing, including those filed by the FERC, California, El Paso, and other parties. App. 151a-52a.

REASONS FOR GRANTING THE WRIT

Whereas consumers in most of the states have significantly benefited from the pricing protection under the Natural Gas Act for wholesales of natural gas, the decision of the Court of Appeals has deprived consumers in the western states, especially California, of such protection with respect to an enormous supply of natural gas transported to them from the San Juan area. The Court of Appeals' reversal of the FERC decision, which had attempted to redress this inequitable and inconsistent result, has created a void in the FERC's jurisdiction in contravention of this Court's leading decisions on the Natural Gas Act and the very purpose of the Act itself.

If the GLAs are found to be jurisdictional sales of gas, the FERC remedy phase, which was near trial when the decision below was issued, would fix the amount to be refunded by the producers. Under the FERC staff's and California's theory of remedy, the GLA producers should be required to refund over $1 billion (including interest) for excessive amounts paid to them between 1974 and October 1, 1983, with California consumers as the main beneficiaries of such refunds.

In addition to denying any relief for these past overcharges, the decision below has caused great uncertainty over the future of this gas supply. The decision below, along with this Court's decision in *Public Service Commission of New York v. Mid-Louisiana Gas Co.*, ... U.S. ..... 103 S.Ct. 3024, 77 L.Ed.2d 668 (June 28, 1983), has led to El Paso's current litigation to reassign the wells. Depending upon the outcome of that litigation and related

FERC proceedings, California is threatened with the possible loss of a vast supply of natural gas or excessive future prices for this gas.

This case is of exceptional importance because the decision below exempts a class of wholesales of natural gas from regulation, greatly impairs the integrity and proper administration of the Natural Gas Act, leaves California and other western states with no remedy for the enormous overcharges paid by their consumers in recent years, and creates great uncertainty in the years ahead.

THE DECISION BELOW CONFLICTS WITH THIS COURT'S LEADING CASES ON THE SCOPE OF THE NATURAL GAS ACT

The Court of Appeals' construction of the Natural Gas Act is irreconcilable with this Court's leading cases on the scope of the Natural Gas Act. In 1954, this Court in the *Phillips* case (*Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954)) ruled that independent producer sales were sales for resale within the meaning of section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b). The promise of *Phillips* was that *all* wholesales of natural gas in interstate commerce were to be regulated. 347 U.S. at 682. A decade later, in the *Rayne Field* case (*United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965)), where it came to this Court's attention that producers could accomplish the equivalent of a producer sale through a sale of leases, the Court held that such a lease-sale was also within section 1(b). The Court enforced as to lease-sales the promise of *Phillips* that *all* wholesales of gas in interstate commerce were under regulation. 381 U.S. at 402.

The decision below erroneously relies on *FPC v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949) ("*Panhandle*"), the principal case that was distinguished in *Rayne Field*. In *Rayne Field*, this Court limited *Panhandle's* holding strictly to its facts—the transfer by an interstate pipeline of leases covering an undeveloped field to a production company for ultimate sale and consumption in *intrastate* commerce. Nevertheless, the *Panhandle* case was an important influence on the decision below, despite this Court's treatment of it in *Rayne Field*.

So far as is now known, the lease-sale transfers in the San Juan area were the first attempt by the gas producing industry to evade the FPC's jurisdiction. They were mostly entered before this Court settled in *Phillips* that the FPC had jurisdiction over producer sales, but at a time that the industry anticipated that the decision in *Phillips* might ultimately be unfavorable. App. 47a-49a. Delhi believed that the Barker Dome and then the GLA-47 lease-sales were not subject to regulation under the *Panhandle* case. It received legal opinions to that effect. App. 49a and 60a.

In rejecting the FERC's decision that the San Juan lease-sales were clearly jurisdictional, the Court of Appeals was persuaded to the contrary because it read this Court's decision in *Rayne Field* as requiring substantial pre-agreement development drilling before a lease-sale could be jurisdictional. App. 15a-16a. California maintains that this was not the intent of the *Rayne Field* decision.

Rayne Field involved sales of leases from a proven field that was also substantially developed by wells. In *Rayne Field*, this Court distinguished *Panhandle* from *Rayne Field* on two grounds: first, that the leases in *Panhandle*

were not substantially developed; second, that *Panhandle* did not involve a sale of natural gas for resale in interstate commerce. 381 U.S. at 403-404. The decision below placed undue emphasis on the first ground of distinction. This Court in *Rayne Field* was not called upon to focus on the fact that lease-sales, in economic effect the equivalent of conventional sales, can be structured where the development drilling has not yet been done; all that is needed is sufficient exploratory drilling on or off the acreage to be made the subject of the lease-sale so that reasonable estimates can be made of the recoverable gas volumes underlying the acreage to be assigned. The cost of development wells is then one of several factors that is taken into account in structuring the consideration of the lease-sale. Still, the lease-sale involves a wholesale of gas regardless of the extent or even the existence of development wells.

Since *Phillips* and *Rayne Field* made clear that Congress intended to regulate all wholesales of gas without exception, it is apparent that wholesales where the development drilling remains to be done are just as jurisdictional as where such drilling has been substantially done before transfer. This is especially true in the present case wherein the substantial development had purposely been temporarily postponed pending sale of the reserves.[13] In view of the GLAs' requirement that El Paso immediately develop the properties, the flow of gas was clearly imminent at the time the agreement was reached. Whether substantial development occurs before the lease-sale agreement is made or immediately upon the closing of the lease-sale, as in the present case, in either situation the lease-sale has

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[13]See discussion, *infra*, p. 20.

"accomplished the transfer of large amounts of natural gas to an interstate pipeline for resale in other states. That is the significant and determinative economic fact. To ignore it would substantially undercut Phillips . . . ." 381 U.S. at 401. The reason, of course, is that it would leave unregulated a major class of wholesales of gas in interstate commerce resulting in the very exploitation of consumers by natural gas producers which the Natural Gas Act was enacted to prevent. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. at 685.

The decision below sharply criticizes the FERC's "economic equivalency/commercial realities approach." App. 14a. However, this is exactly the approach that is required under *Rayne Field*. 381 U.S. at 401. In criticizing the FERC, the Court of Appeals ignored its own prior acknowledgment in *Louisiana Land and Exploration Co. v. FERC*, 574 F.2d 204 (5th Cir. 1978), *cert. denied*, 439 U.S. 1127 (1979) that "[E]conomic realities . . . determine whether a jurisdictional sale has occurred." 574 F.2d at 207. The lease-sale format, first before this Court in *Rayne Field*, was developed by the San Juan producers to avoid FPC regulation. *See* App. 44a-51a, 88a. Because the San Juan lease-sales were the economic equivalent of conventional sales, the FERC's' careful jurisdictional determination was clearly correct.

THE DECISION BELOW CONFLICTS WITH CLEAR PRIOR PRECEDENT THAT DEVELOPMENT DRILLING IS NOT REQUIRED TO ACCOMPLISH A JURISDICTIONAL SALE

The decision below asserts that "the Commission's downplaying of the development issue may well foreshadow the next stage in the evolution of the law . . . ." This is not true. In fact, it has been clear to the industry for a long time that the FERC's jurisdiction does not depend on the extent of development drilling. The FPC in several cases in the 1960s made it clear that this was not the intent of *Phillips* and later *Rayne Field*. The history is reviewed in the Initial Decision, *Tennessee Gas Pipeline Co.*, 38 F.P.C. 703 at 721-23 (1966). The industry tested the FPC's position in one of these cases and it lost. See *Continental Oil Co. v. FPC*, 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910 (1967) ("*Ship Shoal*"). Judge Wisdom's *Ship Shoal* opinion is a landmark decision, and clearly applied the *Rayne Field* principle to new fields, where the development drilling remained to be done.

In *Ship Shoal*, at the time the lease-sale was entered, there was but one gas well, seven oil wells, and four dry holes. The many gas reservoirs required at least four more gas development wells[14] in order to develop all of them. Under the lease-sale, the development cost was shifted to the pipeline, along with the operating expense. Initial

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[14]These wells were deep, offshore wells. Such wells are far more costly to drill and operate than the relatively shallow onshore wells in the San Juan Basin.

Decision, *Tennessee Gas Transmission Co.*, 30 F.P.C. 798, 802-03 (1963). The producers argued at every stage that the *Ship Shoal* reserves were not "substantially developed" because the development drilling remained to be done. Judge Wisdom acknowledged that the development drilling remained to be done (370 F.2d at 66), but found jurisdiction because the lease-sale accomplished the transfer of large amounts of substantially proven reserves, containing definable gas volumes, to an interstate pipeline for resale in interstate commerce, with payment geared to production. *Ship Shoal*, 370 F.2d at 67.

In *Ship Shoal*, the Fifth Circuit devised the "commercial quantities" test (see App. 95a-97a) precisely because of the absence of substantial development in *Ship Shoal*, as the producers therein noted with enthusiastic dissatisfaction in their certiorari petition to this Court.[15] Here, the evidence showed that the GLA-47 reserves were more imminently producible upon development than *Ship Shoal* upon development—Delhi anticipated that El Paso could produce 16.8% (179 Bcf) of the GLA-47 reserves in four years (R.9692) whereas the producers' witness estimated that 10% (73 to 82.3 Bcf) of the *Ship Shoal* reserves could be depleted in four years. 370 F.2d at 66. As shown in the Statement of the Case, the GLA-47 reserves were immediately attached upon closing, development drilling proceeded at a fast pace, and substantial volumes were moving to California within a short time. No comparable facts

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[15]Petition for cert. at pp. 7-10, *Continental Oil Co. v. FPC*, No. 1323, October Term, 1966.

existed in *Ship Shoal*, which was held to be a jurisdictional sale.[16]

The decision below did not consider *Ship Shoal* in light of its facts, and hence did not come to grips with the holding of that decision that substantially proven reserves (without development wells) are enough to accomplish a jurisdictional transfer. 370 F.2d at 67. Rather, according to the decision below, the FERC's jurisdiction depends on the extent of development drilling, yet development drilling often does not take place under either a conventional sale or an equivalent lease-sale until the producer has entered into a contract with a pipeline. Sensibly enough, the producer is not going to invest his capital in development wells until the pipeline is obligated by contract to take the gas and the producer can look forward to a return of his investment, as well as profit.[17] App. 110a-111a. Further, as the present case has dramatically established, a producer controlling a large volume of gas desperately needed in a market area can extract a very high price through the

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[16]Indeed, in *Ship Shoal*, the producers advised this Court not only that the pipeline "would be compelled to proceed with development work following transfer" but also that it could not even "determine until later whether to construct the connecting pipeline depending on the results from further drilling to determine feasibility." Petition for cert., cited in n. 15, *supra*, pp. 9-10.

[17]For example, in the San Juan Basin, Stanolind Oil & Gas Co., the producing arm of Standard Oil of Indiana, entered into a long-term sales contract to sell Mesaverde gas to El Paso in April, 1950. Stanolind initially planned to dedicate 17,320 acres to its contract with El Paso. As of January 1, 1950, DeGolyer and MacNaughton, independent reservoir engineers, estimated that these 17,320 acres contained recoverable reserves of 515 Bcf. R. 9715. At that time, there were two Mesaverde wells on the 17,320 acres.

lease-sale form (as easily as the producer could in a conventional sale) unless restrained by regulation.

Above all, just as proven but undeveloped reserves dedicated under conventional sales contracts are concededly jurisdictional, so also development drilling is not needed to effect a jurisdictional lease-sale. Regulatory effectiveness clearly requires that the FERC exercise jurisdiction over both types of contracts. The FPC and the Fifth Circuit recognized in the 1960s that this was a necessity. As ALJ Benkin wrote in this case:

"The *Rayne Field-Bastian Bay*[18]*-Ship Shoal* trilogy represented a major victory for the FPC. It firmly closed the door upon efforts to use the lease-sale contract as a device to evade the agency's jurisdiction over wellhead sales, including (most importantly) the agency's power to establish ceiling prices for all gas sold to the interstate market." App. 97a-98a. The decision below is a devastating throwback to a regulatory era that was meant to end forever with this Court's decision in *Phillips*.

CONCLUSION

The decision below has sanctioned the circumvention of the Natural Gas Act by certain producers with total disregard to the basic principle that has guided this Court in *Phillips* and *Rayne Field*, the Fifth Circuit in *Ship Shoal*, and the FPC (and FERC) for the last two decades: namely,

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[18]In *Bastian Bay*, which was before this Court at the same time as *Rayne Field*, this Court *summarily* reversed the Tenth Circuit's non-jurisdictional decision. *FPC v. Pan American Petroleum Corp.*, 381 U.S. 762 (1965).

that all wholesales of natural gas in interstate commerce are subject to pricing protection.

Because natural gas wholesales involve a market where end use consumers are largely captive customers, the Natural Gas Act was enacted to prevent exploitation by natural gas producers. Yet the Court of Appeals' decision has deprived millions of consumers of any redress for the past overcharges as well as future protection for prices for this gas notwithstanding Congress' intention to give consumers such remedies.

California therefore respectfully submits that this petition for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit should be granted.

Respectfully submitted,

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Dated: February 8, 1984

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FILED
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ALEXANDER L. STEVAS,
CLERK

83-1321

No. ____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA
AND THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA,

Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,

Respondents.

APPENDIX

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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1. OPINION OF THE COURT OF APPEALS, *EL PASO NATURAL GAS CO.* v. *SUN OIL CO.*, 708 F.2d 1011 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.*
July 5, 1983

Nos. 77-1762, 77-2613 and 80-2404

EL PASO NATURAL GAS COMPANY, *et al.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *et al.*,
Defendants-Appellees.

TENNECO OIL CO., *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

TENNECO OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

Petitions were filed seeking review of orders of the Federal Energy Regulatory Commission which determined that it had jurisdiction over certain lease-sale agreements transferring rights to certain gas-bearing lands in the San Juan Basin of New Mexico and Colorado. After consolidation with a decision of the United States District Court for the Western District of Texas, Dorwin W. Suttle, J., which found that such agreements were not within regulatory jurisdiction of the Commission, the Court of Appeals, Roney, Circuit Judge, held that where reserves underlying the leaseholds were not substantially developed at the time the lease sales were executed

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*Former Fifth Circuit case, Section 9(3) of Public Law 96-452, October 14, 1980.

because of lack of imminent ability to produce in commercial quanities, series of lease-sale agreements transferring rights to certain gas-bearing lands in the San Juan Basin of New Mexico were not sales of natural gas in interstate commerce within meaning of Natural Gas Act and were therefore beyond regulatory jurisdiction of Federal Energy Regulatory Commission.

Appeal from district court's decision affirmed; one petition for review dismissed and the other reversed.

Daniel Joseph, Jack W. Hanks, Daniel Watkiss, Washington, D.C., Donald C. Shepler, Salt Lake City, Utah, David K. Watkiss, Jack D. Bachman, Salt Lake City, Utah, for Northwest Pipeline Corp.

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Howard V. Golub, Shirley A. Woo, Malcolm H. Furbush, San Francisco, Cal., for Pacific Gas & Elec. Co.

Charles F. Hawkins, Dallas, Tex., for Southern Union Co.

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Steven A. Taube, Atty., George H. Williams, Jr., Jerome Nelson, Sol., Washington, D.C., for amicus curiae F.E.R.C.

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Craig W. Hulvey, Washington, D.C., Robert D. Haworth, Houston, Tex., for Mobil Oil Corp.

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Thomas Burton, Jr., Houston, Tex., for Continental Oil Co.

W.B. Browder, Jr., Midland, Tex., for W. Watson LaForce, et al.

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William M. Lange, Colorado Springs, Colo., for Colo. Interstate Gas Co.

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Robert L. Simpson, Spokane, Wash., for Wash. Water Power Co.

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Lester D. Sitter, Denver, Colo., for Rocky Mountain Natural Gas Co., Inc.

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J. Richard Tiano, Washington, D.C., for Intermountain Gas Co.

Wm. W. Bedwell, Washington, D.C., for Southwest Gas Corporation.

Michael S. Gilmore, Deputy Atty. Gen., Boise, Idaho, for Idaho Pub. Utilities Comm.

Appeal from the United States District Court for the Western District of Texas.

Petitions for Review of Orders of the Federal Energy Regulatory Commission.

Before BROWN, RONEY and TJOFLAT, Circuit Judges.

RONEY, Circuit Judge:

The basic question presented by these consolidated appeals is whether a series of lease-sale agreements transferring rights to certain gas-bearing lands in the San Juan Basin of New Mexico are sales of natural gas in interstate commerce within the meaning of section 1(b) of the Natural Gas Act, 15 U.S.C.A. § 717(b). Holding the agreements are not sales as defined by the Act, and are therefore beyond regulatory jurisdiction, we affirm the district court judgment to that effect and reverse the decision of the Federal Energy Regulatory Commission to the contrary.

Before considering a case of this kind, it is necessary to remind ourselves that the Commission's power to regulate the economics of natural gas transactions has been limited by Congress. Although it presumably has the power to regulate every nook and cranny of the natural gas business, Congress chose not to do so. *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 502, 69 S.Ct. 1251, 1254, 93 L.Ed. 1499 (1949). In this situation, it is important that the courts restrict the regulatory agencies to precisely that authority delivered to them by Congress, and to stop where Congress intended to stop no matter how tempting it might be to hearken to persuasive arguments that more regulation is appropriate. Agencies have a tendency to perceive a need for regulation. Congress is the determinative body in the matter, however, and this case has been considered and decided on that precise premise. If Congress had intended to regulate the transactions here involved, it easily could have done so with simple legislative language. We make no judgment whether it should have done so. We only decide, based upon the leading Supreme Court decision and the prior precedent of this Court, that it did not.

Before reviewing the facts and getting on with the decision, it might be helpful to describe the parties to this litigation while

footnoting the names of all litigants, to state briefly the source of these appeals and the lengthy history of the litigation, and in a simplified way to suggest the issues that have been presented for decision.

THE PARTIES

On one side of this litigation are two pipeline companies,[1] which acquired leasehold rights in gas-bearing lands, and the Federal Energy Regulation Commission. On the other side are numerous oil and gas concerns and a few individuals who transferred the leasehold rights in question.[2] A number of state commissions and interested private entities have been granted permission to intervene or file amicus briefs.[3]

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[1] El Paso Natural Gas Company and Northwest Pipeline Corporation.

[2] Sun Oil Company, Atlantic Richfield Company, Mobil Oil Corporation, Tenneco Oil Company, Continental Oil Company, American Petrofina Company of Texas, Union Oil Company of California, Crown Central Petroleum Corporation, Delta Drilling Company, Amoco Production Company, Phillips Petroleum Company, F.H.N., Ltd., Getty Oil Company, W. Watson Laforce, Jr., Morris and Flora Mizel, William G. Webb, *et al.*, Robert Beamon, individually and as trustee, Thomas L. Hail, Trustee, and Pattie Ann Beamon Lundell.

[3] Washington Utilities and Transportation Commission, The People of the State of California, The Public Utilities Commission of the State of California, The Public Utility Commissioner of Oregon, City of Ellensburg, Washington, The Public Service Commission of Nevada, The Public Service Commission of Wyoming, Idaho Public Utilities Commission, Pacific Gas and Electric Company, Southern California Gas Company, Southern Union Company, C.P. National Corporation, Colorado Interstate Gas Company, Cascade Natural Gas Corporation, Northwest Natural Gas Company, Rocky Mountain Natural Gas Company, Intermountain Gas Company, Southwest Gas Corporation, Mountain Fuel Supply Company, Washington Natural Gas Company, and Washington Water Power Company.

HISTORY OF THE LITIGATION

During the 1950s, Tenneco Oil, Sun Oil, Continental Oil, Atlantic Richfield, Phillips Petroleum, and several other oil companies entered into gas lease-sale agreements with El Paso Natural Gas Company and Pacific Northwest Pipeline Company, both gas pipeline companies. In return for their working interests in certain leases in the San Juan Basin of New Mexico and Colorado, the oil companies were to receive so-called overriding royalties or production payments. The rates established for these royalties were subject to redetermination at the expiration of the initial term. If at the expiration of the term the parties could not agree on a new rate, the rate was to be fixed by arbitration.

In 1973, Sun Oil and El Paso failed to agree on a new override rate, and the dispute was submitted to arbitration. The arbitration board awarded Sun Oil an override based on the well head price of *intrastate* gas which exceeded the regulated *interstate* rate. Other oil companies then sought redetermination of their rates, and El Paso thereafter brought four actions in the United States District Court for the District of Columbia seeking a declaratory judgment that the royalty recipients were selling gas in interstate commerce within the meaning of section 1(b) of the Natural Gas Act, 15 U.S.C.A. § 717(b). If in interstate commerce, the lease-sale agreements came within the jurisdiction of the Natural Gas Act, and the royalty recipients could not receive more than the interstate rates established by the Federal Power Commission (now the Federal Energy Regulatory Commission).

The suits were consolidated and transferred to the Western District of Texas. 28 U.S.C.A. § 1406. El Paso sought reference of the case to the Commission, and the district court carried the request with the case. At the same time, El Paso filed a complaint with the Commission seeking a determination as to the status of the leases under the Act. After a protracted trial, the district court held the lease-sale agreements were not sales of gas within the meaning of the Act and dismissed the case for want of jurisdiction, implicitly denying El Paso's mo-

tion for reference to the Commission. *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 426 F.Supp. 963 (W.D.Tex.1977). El Paso appealed, moving this Court to refer the matter to the Commission.

The Commission thereafter issued an order instituting a show cause proceeding directed to the jurisdictional issue. *El Paso Natural Gas Co.*, 58 F.P.C. 2181 (1977). Tenneco Oil, Atlantic Richfield, Sun Oil, and others sought review of the order in this Court. We denied their motions to stay the Commission's show cause proceeding but withheld decision of the appeal from the district court pending receipt of the Commission's opinion. *Tenneco Oil Co.* v. *FERC*, 580 F.2d 722 (5th Cir.1978).

A record was fully developed before an administrative law judge. Affirming and adopting the decision of the administrative law judge, the Commission ruled that the lease-sale agreements were within its jurisdiction. *El Paso Natural Gas Co.*, 12 F.E.R.C. ¶ 61,297 (1980). Petitions for review of the Commission's decision were thereafter filed with this Court.

Thus the district court and the Commission, albeit on different records, reached opposite conclusions. Both decisions came before us for review. We heard extended oral argument in October 1981, permitted supplemental briefing to the end of that year and continued to receive helpful memoranda through April 1982.

THE ISSUES

The basic question that confronts the Court on these appeals is whether the natural gas lease-sale agreements are sales of gas within the meaning of the Natural Gas Act, 15 U.S.C.A. § 717-717w. Underlying this ultimate issue are subissues which seem to be no longer critical in light of our decision: (1) since the district court decision preceded the Commission's decision, did it have a *res judicata* effect that bound the Commission? (2) having litigated and lost in the district court, were El Paso and Northwest collaterally estopped from claiming

before the Commission that the transactions are jurisdictional? (3) was the Commission bound to treat the transactions as nonjurisdictional because of its prior rulings in connection with such transfers involving some of the same parties and the same basic facts? and (4) should the district court have referred the jurisdictional issue to the Commission under the doctrine of primary jurisdiction? Other subissues argued but not decided are: (a) whether the Commission prejudged the issues, (b) whether the petitions for review in No. 77-2613 concerning the Commission's decision to conduct a show-cause proceeding on the jurisdictional issue should be dismissed for seeking review of nonfinal interlocutory orders, and (c) whether the Commission's resolution of the jurisdictional question should be given only advisory effect in the court of appeals.

FACTS

The San Juan Basin is located mainly in northwestern New Mexico, with a part extending northward into Colorado. Underlying the Basin are bowl-shaped sandstone formations permeated by large volumes of natural gas. There are three gas productive formations in the Basin: Pictured Cliffs, Mesa Verde, and Dakota. All three are characterized by low to moderate permeability and low porosity. As the district court correctly found, actual drilling is the only method of definitely locating recoverable gas saturations.

Unable to obtain all the gas reserves it desired through conventional wellhead sales, El Paso in 1951 entered into negotiations with Delhi Oil Corporation, a lease holder in the Basin. Delhi and El Paso entered into the first of the lease-sale transactions in issue in this case, GLA (Gas Lease Agreement) 47, in March 1952. In exchange for Delhi's gas reserve acreage, El Paso agreed to pay Delhi a fixed price per Mcf produced, subject to escalation over a specified period of time and thereafter subject to redetermination at the fair market value of the gas. The parties agreed to submit to arbitration any price they could not settle upon.

El Paso's program of acquiring gas reserves in the San Juan Basin, through transactions similar to GLA-47, proceeded rapidly. In all, over a six-year period, El Paso entered into 36 such lease-sale contracts with the owners of gas leaseholds in the Basin, thereby acquiring the gas underlying more than a quarter of a million acres. Thirty-five of these GLAs are in issue here. Prior to the lease-sale transactions, natural gas from some of the acreage had been sold to El Paso under conventional wellhead sales contracts.

All the GLAs followed the same general pattern: in exchange for the producer's agreement to transfer the leasehold, El Paso agreed to make overriding royalty payments for the gas when produced.

In 1952, Pacific Northwest Pipeline Corporation, a prospective interstate natural gas pipeline company, filed an application with the Commission for a certificate of convenience and necessity to build a pipeline to supply gas to the Pacific Northwest market. Since Pacific Northwest had no gas supplies, it sought commitments from independent producers who owned substantial reserves in the San Juan Basin.

Pacific Northwest obtained commitments for San Juan Basin gas from several producers based on a lease-sale format (called "PLAs" for Pacific Lease Agreement) closely similar in most important respects to the GLAs in the El Paso transactions. The basic scheme called for Pacific Northwest to compensate the interest owner of the acreage by paying an overriding royalty, calculated as a specified sum for each Mcf of gas produced from the acreage, subject to periodic escalation. The price was also subject to later redetermination under a specified formula tied to the market, *i.e.*, the unregulated value of the gas. The PLAs conveyed rights only to gas, not oil.

Northwest Pipeline Corporation is the successor in interest, through El Paso, of Pacific Northwest.

JURISDICTIONAL ISSUE

Whether the gas lease-sale agreements are sales of gas within the meaning of the Natural Gas Act, 15 U.S.C.A. § 717-717w, and thus subject to the jurisdiction of the Federal Energy Regulatory Commission, is of substantial significance. If they are sales under the Act, the royalty recipients must seek certification from FERC and cannot receive payments exceeding the regulated interstate rate. If they are not sales, the recipients are entitled to the rate provided in the contracts.

The issue is difficult to decide. Neither the statute nor the cases give definitive direction. Congress intended to regulate only interstate sales of natural gas, leaving intrastate sales and the *production* of gas regulated exclusively by the states, if regulated at all. *See Interstate Natural Gas Co.* v. *FPC*, 331 U.S. 682, 690, 67 S.Ct. 1482, 1487, 91 L.Ed. 1742 (1947). An easy line to draw in legislative halls, in the real world there is much confusion between sales and production, made ever increasingly so by legal craftsmanship that sometimes makes production look like sales, or sales look like production, depending upon the interest of the client.

The main cases addressing the question focus on the geology and development of the acreage and the terms of the contracts involved. The fountainhead decision setting forth the factors to apply in determining whether a transaction is jurisdictional is *United Gas Improvement Co.* v. *Continental Oil Co. ("Rayne Field")*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965). The significant case in this Circuit is *Continental Oil Co.* v. *FPC ("Ship Shoal")*, 370 F.2d 57 (5th Cir. 1966).

While ordinary wellhead sales of natural gas for resale in interstate commerce come within the jurisdiction of the Natural Gas Act, *see Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 677, 681-82, 74 S.Ct. 794, 796, 798-99, 98 L.Ed. 1035 (1954), lease transfers and the royalties collected thereunder are generally within "production or gathering" exemption of the Act, 15 U.S.C.A. § 717(b), and thus not jurisdictional. *See Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C.Cir.1971), *cert.*

denied, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 (1972). Difficulties arise, however, where, as in the instant case, the transactions are hybrid, manifesting characteristics of both arrangements.

In the leading case of *United Gas Improvement Co.* v. *Continental Oil Co.*, commonly known as "Rayne Field," the United States Supreme Court directed a case-by-case analysis of hybrid lease-sale arrangements, the fundamental inquiry being whether "the sales of these leases in . . . a proven and substantially developed field . . . accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states." 381 U.S. at 401, 85 S.Ct. at 1522. The Fifth Circuit expounded on the *Rayne Field* test in *Continental Oil Co.* v. *F.P.C. ("Ship Shoal")*, stating the test as follows:

> (1) Is the economic effect of the transfer similar to that of a conventional sale?
>
> (2) Is the subject of the transaction "proven and substantially developed" reserves?
>
> (3) Is the transfer of the reserves for purpose of interstate transmission and resale?

370 F.2d at 62. *Ship Shoal* further articulated the standard for applying the second factor, whether reserves are "proven and substantially developed" within the meaning of *Rayne Field*, focusing on (1) definability of gas volume based upon proof of reserves and (2) imminent ability to produce in commercial quantities. *Id.* at 63-64.

While both the administrative law judge's decision and that of the Commission invoke *Rayne Field*, it is clear from a careful reading of the administrative law judge's opinion and the Commission's affirmance that neither correctly applied it under the law of this Circuit. In determining whether a transfer is jurisdictional under the Act, *Ship Shoal* teaches that all three of the above factors must be present. The administrative law judge and the Commission, however, elevated the first prong—economic equivalency—from a component in the *Rayne Field*

test to the determinative factor on the issue. Thus, the administrative law judge stated:

> Under the *Rayne Field* case's "economic equivalent" doctrine, a lease-sale agreement would clearly be subject to regulation as a jurisdictional sale of gas at the wellhead if it is held to be economically equivalent in substance to the conventional wellhead sale which the Court held to be jurisdictional in *Phillips*.
>
> * * * * * *
>
> The legal principles fashioned in the *Rayne Field* line of cases, when applied to the facts of this proceeding, lead inescapably to the conclusion that all of the lease-sale agreements at issue are jurisdictional. The crucial test that emerges from the cases is whether a particular transaction accomplished the transfer of large volumes of natural gas reserves to an interstate pipeline for resale in interstate commerce. If it did, the transaction is jurisdictional.
>
> * * * * * *
>
> What is significant is the essential message of *Rayne Field*—that the transfer of large amounts of natural gas reserves to an interstate pipeline for resale in interstate commerce is a jurisdictional transaction, no matter how the lawyers decide to structure the transfer. *Rayne's* specification that "proven and substantially developed reserves" must be present is not a quantitative test, a license for future courts and Commissions to engage in massive well counting in order to ascertain whether some formulaic criterion has been satisfied. Rather, *Rayne* is concerned with commercial realities. It asks whether what was sold was gas or merely the right to explore for and develop it in the uncertain event it is found.
>
> * * * * * *
>
> Here, too, the significant economic fact that will not go away no matter how much the respondents try to wish it away is that the GLA and PLA contracts at issue, each and every one of them, transferred large volumes of natural gas from a producer of natural gas to an interstate natural gas pipeline for transmission and sale for resale in other states. That fact requires the finding that each of the contracts was, as a matter of law, economically equivalent

> to a wellhead sale of natural gas for resale in interstate commerce.

El Paso Natural Gas Co., 6 F.E.R.C. ¶ 63,037, at 65,212; 65,217-19 (1979). In affirming, the Commission held:

> We find the magnitude of the overriding royalties and the fact that they apply to each Mcf of gas sold, irrespective of the quanitities of gas the contracting parties might originally have thought were involved, lends, in our judgment, strong support to the proposition that these lease sales were virtually identical in "economic effect" to conventional sales.

El Paso Natural Gas Co., 12 F.E.R.C. ¶ 61,297, at 61,683 (1980).

By focusing on "commercial realities" and the parties' assumption while negotiating that gas existed in the ground, the administrative law judge and the Commission misread and misapplied *Rayne Field* and *Ship Shoal*, almost ignoring the requirement for a finding of jurisdiction under the Natural Gas Act that the acreage involved must be proven and substantially developed. *See Ship Shoal*, 370 F.2d at 62. Neither the Supreme Court nor our precedents have signaled a retreat from this requirement or indicated it is swallowed up by the first prong of *Ship Shoal's* test. Thus, in holding the lease-sales jurisdictional in *Rayne Field*, the Supreme Court emphasized that the land included "proven and substantially developed" gas reserves. 381 U.S. at 401, 85 S.Ct. at 1522.

Carried to its logical conclusion, the Commission's economic equivalency/commercial realities approach could render any sale of lease rights to an interstate pipeline company jurisdictional merely because the transaction ultimately results in successful production and disposition of gas in interstate commerce. Certainly, El Paso entered into the agreements in question in this litigation with the hope and expectation of obtaining gas for sale in interstate commerce. It had the same goal as a purchaser in the ordinary wellhead sale. But this statement is equally true of the lessee in a traditional transfer of a lease to gas-bearing lands. Unless all the *Rayne Field*

factors, including proven and substantial development, are satisfied, such a transaction is not jurisdictional. *See Mobil Oil Corp.* v. *FPC*, 463 F.2d at 261-62; *see also FPC* v. *Panhandle Eastern Pipeline Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949). The Supreme Court emphasized the difference in degree of development in explaining why it held the transaction jurisdictional in *Rayne Field*, but nonjurisdictional in *Panhandle*. *Rayne Field*, 381 U.S. at 403, 85 S.Ct. at 1523. While the Commission's down-playing of the development issue may well foreshadow the next stage in the evolution of the law, for the time being our precedents demand full application of all components of the *Rayne Field* test, including the proven and substantial development factor, as explained in *Ship Shoal*. We perceive the *Rayne Field* test to reflect the Supreme Court's concern with the apparent congressional intent not to regulate production. A purely economic test would seem to encroach on that concern.

Focusing on the "proven and substantially developed" component of *Rayne Field* and *Ship Shoal*, the record reveals the reserves in the Basin may well have been "proven" at least within reasonable estimates. *See generally Ship Shoal*, 370 F.2d at 64-65. The district judge was correct, however, in deciding the lease-sale agreements did not involve substantially developed reserves, and the Commission erred in determining the same transfers did. Specifically, we hold the reserves underlying the leaseholds were not substantially developed at the time the lease sales were executed because of the lack of "imminent ability to produce in commercial quantities." *Ship Shoal*, 370 F.2d at 64.

An important factor in our decision is the limited extent to which the Basin had been drilled at the time the GLAs and PLAs were executed. Although different tracts varied as to development, taking the Basin as a whole, the acreage was far less drilled than the land covered by the agreements found jurisdictional in *Rayne Field*. Unlike in that case, massive efforts were required to make the fields in the Basin commercially productive. For example, GLA No. 47 covered approxi-

mately 102,400 acres. At the time of the signing of the agreement, there were fifteen wells in the Mesa Verde formation and nine in the Pictured Cliffs formation included under the GLA. State law, however, permitted far more extensive drilling: one Mesa Verde well for each 320 acres and one Pictured Cliffs well for each 160 acres. Substantial drilling took place after the agreement was reached. By December 1976, 736 wells were in the ground. An even more dramatic example of the lack of substantial development when the agreements were reached is provided by PLA-5. At the time of the agreement, there were no wells on the 188,000 acres. By December 1977, however, 365 wells were productive. Although a few GLAs and PLAs reflect substantial development, neither the Commission nor the parties have sought to approach the issue here on an individual agreement basis.

In comparison, the acreage in *Rayne Field* featured far more development prior to execution of the agreements. In *Rayne Field*, nineteen wells were in the ground with only seven more to be drilled. 381 U.S. at 396 n.3, 85 S.Ct. at 1520 n.3. This significant drilling enabled the purchaser-lessee to receive gas for interstate distribution shortly after execution. *Id.* at 397, 85 S.Ct. at 1520.

The evidence in the present litigation reveals that the few wells in the ground when the agreements were executed could not have come close to depleting the acreage. For example, even after adding numerous wells in the land covered by GLA-47, the purchaser-lessee sought and received permission to double the number of wells previously allowed under state law in the Mesa Verde formation. According to the purchaser-lessee, the party favoring Commission jurisdiction and arguing the reserves were substantially developed, the additional wells were necessary to deplete the formation.

While the number of wells existing at execution of the agreement is not the *sine qua non* of substantial development, the Commission has considered this factor, and the cases point up its significance. *E.g.*, *Rayne Field*, 381 U.S. at 396 & n.3, 403 &

n.8, 85 S.Ct. at 1520 & n.3, 1523 & n.8; *Texas Gas Transmission Corp.*, Docket No. CP77-612, "Findings and Order After Statutory Hearing Issuing Certificate of Public Convenience and Necessity and Granting Petition to Intervene," at 3 (May 10, 1978). Since substantial development turns on whether the acreage is capable of imminent production of natural gas in commercial quantities, *Ship Shoal*, 370 F.2d at 64, it stands to reason that the actual number of wells in comparison to the number needed to complete production from the land is a relevant factor. As the Supreme Court stated in explaining the relevance of the substantial development criteria, "the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce." *Rayne Field*, 381 U.S. at 403, 85 S.Ct. at 1523. The pipeline companies' ability to tie in a few wells shortly after consummation of the transaction does not demonstrate an "imminent ability to produce in *commercial* quantities," *Ship Shoal*, 370 F.2d at 64 (emphasis added), or *substantial* development. We therefore conclude that because the acreage was not substantially developed, the agreements in issue were not sales of gas under the Natural Gas Act.

The pipeline companies urge and the Commission ruled that even if the lease-sales were not covered by the Act at the outset, they "ripened" into jurisdictional transactions when the price paid under the contracts was redetermined through the much later 1973 arbitration. Relying on *Weymouth* v. *Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir.1966), the Commission held the price redetermination proceedings constituted a reassertion of "control over the price of gas sold at a time when the gas was undeniably from a proven and substantially developed field." *El Paso Natural Gas Co.*, 12 F.E.R.C. ¶ 61,297, at 61,684 (1980).

We reject the Commission's approach because it is implicit in the controlling authorities that jurisdiction must be evaluated at the time lease-sale agreements are executed. In *Rayne Field*, the Supreme Court found the gas reserves proven and

substantially developed at the time the lease-sales were signed. *See* 381 U.S. at 396, 85 S.Ct. at 1520. Similarly, the Fifth Circuit in *Ship Shoal* treated the pipeline company's readiness to connect to the field upon execution as a "strong indication that the field was 'substantially developed' at the *time of transfer.*" 370 F.2d at 65 (emphasis added).

Weymouth, relied on by the Commission, is inapposite. In that case, the parties entered into a new lease which superseded various individual leases and incorporated many substantial changes. The Fifth Circuit referred the case to the Commission for a jurisdictional determination, noting the applicability of the Natural Gas Act to agreements reached or significantly altered after the date of its enactment. 367 F.2d at 102. In the instant case, however, redetermination of rates followed precisely according to the terms of the lease-sale agreements which remained unchanged. The mere redetermination of rates pursuant to the original contracts does not render the arrangements sales and is not factually analogous to the exercise of a retained right to withhold consent to sublease or assign, deemed jurisdictional in *Louisiana Land and Exploration Co.* v. *FERC*, 574 F.2d 204 (5th Cir.), *cert. denied*, 439 U.S. 1127, 99 S.Ct. 1043, 59 L.Ed.2d 88 (1979). Thus, in the absence of authority commanding a contrary rule, we hold the agreements must be evaluated for jurisdiction under the Natural Gas Act as of the date of execution.

PRIMARY JURISDICTION, RES JUDICATA, COLLATERAL ESTOPPEL

The issue concerning FERC's statutory jurisdiction was pending simultaneously before both the agency and the district court. Throughout this litigation both the purchaser-lessees and the Commission have consistently maintained that under the doctrine of primary jurisdiction, the agency's expert and specialized knowledge should have been utilized from the outset and that the district court erred in failing to refer the case to the Commission for initial determination.

Whether the district court should have referred this action to the Commission under the doctrine of primary jurisdiction is, at this juncture, without consequence. Our decision in this case has been preceded by and we have considered *both* tribunals' decisions so that the spirit of the flexible doctrine, if not the letter, has been satisfied. *Cf. J.M. Huber Corp.* v. *Denman*, 367 F.2d 104, 111 (5th Cir.1966) (primary jurisdiction is a flexible doctrine). Beyond holding that we did not, as has been argued, refer the jurisdiction issue to the Commission in *Tenneco Oil Co.* v. *FERC*, 580 F.2d 722 (5th Cir.1978), this question requires no further analysis.

Similarly, we need not decide the res judicata or collateral estoppel effect, if any, of the district court opinion vis-a-vis the decision of the Commission. Our holding that the district court decision is not clearly erroneous as to the lease-sale agreements before it and that the Commission's ruling is not supported by substantial evidence obviates the need for a detailed discussion of these issues. Those parties claiming the Commission's actions were precluded by the doctrine, especially William G. Webb, et al., prevail under our approach even without their rationale. *See William G. Webb*, 49 F.P.C. 17(1973).

NO. 77-1762: AFFIRMED.

NO. 77-2613: DISMISSED.

NO. 80-2404: REVERSED.

2. ORDER OF FEDERAL ENERGY REGULATORY COMMISSION AFFIRMING INITIAL DECISION AND INITIATING FURTHER HEARING, *EL PASO NATURAL GAS CO.*, 12 FERC ¶ 61,297 (SEPTEMBER 25, 1980)

12 FERC ¶ 61,297

El Paso Natural Gas Company, Docket No. CP74-314; Northwest Pipeline Corporation, Docket No. CP76-327; Sun Oil Company, et al., Docket No. CI77-526

Order Affirming Initial Decision and Initiating Further Hearing

(Issued September 25, 1980)

[Initial decision issued February 20, 1979 appears at 6 FERC ¶ 63,037.]

Syllabus

Commission *affirms* without modification that a series of lease-sale agreements constituted sales of natural gas for resale in interstate commerce under the Natural Gas Act.

[1] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *finds* that overriding royalty owners initially received approximately the same net amount under lease-sale contracts as would have been received under conventional wellhead sales after costs of production were considered. The magnitude of the overriding royalties and the fact that they apply to each Mcf of gas sold, irrespective of the quantities of gas the contracting parties might originally have thought were involved, strongly supports this finding and leads the Commission to *conclude* that the lease-sales are jurisdictional.

[2] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *finds* that persons acquiring leases of land later sold to pipelines were not real estate speculators. Instead these lease-sales accomplished the transfer of natural gas to an interstate pipeline company for resale in other states. The sellers bought leases from the original landowners and sold the gas contained in those leases to the pipelines. The original

landowners received a standard royalty for the rights which they sold and controlled no aspects of the ultimate sale of the gas to pipelines. The Commission also *finds* the inclusion of take-or-pay provisions and the section of noncommercial acreage provision in the lease-sale contract between pipelines and those acquiring the leases leads to the conclusion that gas, not land, was being sold.

[3] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *reaffirms Weymouth* decision in finding that the lease-sales in question are subject to Commission jurisdiction. Assuming *arguendo* that the lease-sales were not initially jurisdictional, they became so at the time the price paid for the gas pursuant to the contracts was redetermined through arbitration and thereby established at levels equal to or approaching prevailing wellhead prices. Upon redetermination of price, the sellers reasserted their control over the price of gas sold at a time when the gas was undeniably from a proven and substantially developed field.

[4] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *rejects* argument that Commission is barred by the doctrines of *res judicata* and collateral estoppel from holding lease-sale transactions to be jurisdictional. *Webb-Turner* did not directly decide that lease-sales were non-jurisdictional. That ruling was based on less than a complete record and reached under different circumstances. In light of the increasing burden on consumers of non-regulation of these lease-sale transactions, the FPC was compelled to throughly examine these lease-sales to determine whether they were jurisdictional. After redetermination of prices, changes in fundamental facts further necessitated a review of the jurisdictional issue. The Commission has also been ordered by the Fifth Circuit to decide whether the subject lease-sale contracts are sales of

natural gas for resale in interstate commerce as defined by the Natural Gas Act.

[5] PIPELINE-RATEMAKING & REGULATION

Refunds & Restitution

Commission *remands* for determination of the remedial measures to be taken, including: (1) whether and if so to what extent payments made by pipelines to overriding royalty owners were excessive and therefore unlawful; (2) what amounts, if any, should be required to be refunded by royalty owners to pipelines and flowed through by them to their jurisdictional customers; and (3) what level of royalties should be approved for the future.

Paul R. Connolly, J. Alan Galbraith and *Arthur R. Formanek* for El Paso Natural Gas Company

David K. Watkiss, Jack W. Hanks and *Joseph T. Casey* for Northwest Pipeline Corporation

Gordon Gooch and *Charles M. Darling, IV* for Tenneco Oil Company, Continental Oil Company, American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company and Mr. & Mrs. Morris Mizel

Michael J. Henke and *MaryJane Reynolds* for Union Oil Company of California

Craig W. Hulvey for Mobil Oil Corporation and Getty Oil Company

George Mickum, Steven H. Brose and *Edward Leahy* for Atlantic Richfield Company

Leo J. Hoffman for Sun Oil Company (Delaware)

John L. Williford and *Larry Pain* for Phillips Petroleum Company

R. H. Landt for Amoco Production Company

Terry R. Barrett and *Stanley L. Cunningham* for F.H.N., Ltd.

William B. Browder, Jr. for W. Watson LaForce, Jr., *et al.*

J. O. Terrell Couch for Robert Beamon, *et al.*

Sherman S. Poland and *Bernard A. Foster, III* for William G. Webb, *et al.*

John S. Fick and *Thomas D. Clarke* for Southern California Gas Company

Shirley A. Woo, Malcom Furbush and *Peter Hanson* for Pacific Gas and Electric Company

Edwyn R. Sherwood, Henry E. Brown and *Joel L. Greene* for Colorado Interstate Gas Company

Bruce R. Debolt and *John H. Socolofsky* for the Oregon Public Utility Commissioner

Radovan Z. Pinto for the People of the State of California and the California Public Utilities Commission

Richard E. Kelly for the Staff of the Federal Energy Regulatory Commission

Before Commissioners: Charles B. Curtis, Chairman; Georgiana Sheldon, Matthew Holden, Jr. and George R. Hall.

[Order Text]

On February 20, 1979, the presiding administrative law judge issued an initial decision in the above-captioned proceeding. The judge found that a series of lease-sale agreements, which are the subject matter of this proceeding, constituted sales of natural gas for resale in interstate commerce under the Natural Gas Act. We agree with the judge's determination and find nothing in the exceptions thereto warranting modification of his decision.

[1] We do, however, want to stress several factors leading to the conclusion that the lease-sales at issue are in fact jurisdictional. The law judge found that the overriding royalty owners initially received approximately the same net amount under the lease-sale contracts as they would have received under conventional wellhead sales after costs of production were considered. The presiding judge also noted that when the overriding royalty payments were redetermined as provided

for in the lease-sale contracts, they were established at the fair-market value of wellhead sales in the case of the contracts of El Paso Natural Gas Company, and at 75% of wellhead value in the case of the contracts now held by Northwest Pipeline Company. The overriding royalties were to be paid on each Mcf of gas produced. These payments are sharply different from payments normally made in a royalty situation. In an ordinary royalty contract, the royalty owner is paid a royalty based on a percentage of the value of production. Here, however, the royalty owners are receiving royalties based on the fair-market value at wellhead for each Mcf produced. These payments are virtually equivalent to the payments that would have been received in a conventional wellhead sale except that in an ordinary wellhead sale the producers would be expected to absorb the costs of production. In this case, of course, the royalty owners are responsible for none of the production costs. The pipelines are instead responsible for production costs and such costs are passed on to their customers (and to the ultimate consumer) in addition to the overriding royalties paid to the lessors. We find that the magnitude of the overriding royalties and the fact that they apply to each Mcf of gas sold, irrespective of the quantities of gas the contracting parties might originally have thought were involved, lends, in our judgment, strong support to the proposition that these lease sales were virtually identical in "economic effect"[1] to conventional sales.

[2] The law judge also found that persons who acquired the leases and sold them to the pipelines were not real estate speculators. The sellers bought leases from the landowners and then sold the gas contained in those leases to the pipelines. The landowners, who were the original sellers of the leases, received a standard royalty for the rights which they sold. They negotiated that royalty with the persons who sold the

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[1] *United Gas Improvement Co.* v. *Continental Oil Co.* ("Rayne Field"), 381 U.S. 392, 396 (1965).

leases to the pipelines. The original landowners had no control over the ultimate destination of any gas which might be discovered, and no knowledge whether the gas, if discovered, will be sold interstate or intrastate. Nor did the landowners control the quantity to be sold, the price to be paid, or the identity of the purchaser. The middlemen sellers controlled all these incidents of sale. They sold the gas to the interstate pipelines, specified how much was to be sold per year, negotiated the price, and dealt with the purchasing pipelines. The sellers of these lease-sale agreements were not landowners selling rights to drill. They were sellers of the natural gas contained in acreage which they had leased from landowners.

[2] We also wish to stress certain contractual provisions which lead us to the conclusion that it was gas, proved reserves, which was being sold. The take-or-pay provisions, and the return of non-commercial acreage provisions, are significant in our determination that what was being sold was gas.

[2] The take-or-pay provisions are commonly found in conventional sales contracts and support our conclusion that these transactions contemplated the sale of proved reserves. Moreover, the return of non-commercial acreage provisions show that all that was being sold was proved reserves as measured by the results of actual drilling. The only difference between these lease sales and producer sales, which may include clauses giving the buyer an option not to attach reserves from wells deemed non-commercial,[2] is the fact that the buyers incurred the risks and costs associated with drilling. Yet this difference is one which, in our view, supports, and certainly does not detract, from our conclusion that these agreements are the functional equivalent of sales from successful wells by producers. We conclude that the evidence amply demonstrates that

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[2] *See Mitchell Energy Corporation*, Docket No. CI78-704, Order Denying Petition For Declaratory Order, Directing Applicant to File For Abandonment Authorization and Granting Intervention (October 23, 1979, 9 FERC ¶ ____).

these lease sales "accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States."[3]

[3] In support of the proposition that the lease-sales in question are subject to the Commission's jurisdiction, the staff cites several cases including *United States* v. *Southwestern Cable Co.*, 392 U.S. 157 (1968), *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971) and *Fanny Fern Weymouth* v. *Colorado Interstate Gen. Co.*, 367 F.2d 84 (5th Cir. 1966). We are not persuaded that either the *Southwestern Cable* or *Mobil* case is directly relevant to the jurisdictional issue presented in this case. However, we do believe that support for the assertion of Commission jurisdiction is provided by *Weymouth*. In that case the court stated:

> Unlike *Huber* which involves a lease from the Landowner to the Lessee-Producer who in turn sells the gas to Northern, the Pipeline Purchaser, this transaction from its inception was a one-step affair. It is between the Landowner-Lessor and the Pipeline as Lessee and Purchaser. Considering that the Natural Gas Act applies from the date of its enactment, at least to all transactions which come into being or are significantly altered thereafter—whether the parties are aware of the existence of the legislation or whether it is being actively enforced—there is at least a possibility that, taking into account the nature and extent of the reserves of this huge gas field, at some stage or time and to some extent, this transaction ripened into a "sale" of a kind comparable to that found to exist in Rayne Field. (367 F.2d at 102).

[3] Assuming *arguendo* that the lease-sales here were not initially jurisdictional, we think that they became jurisdictional at the time the price paid for gas pursuant to these contracts was redetermined through arbitration and thereby established at levels equal to or approaching prevailing wellhead prices.

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[3] 381 U.S. at 401.

Upon the redetermination of price, the sellers reasserted[4] their control over the price of gas sold at a time when the gas was undeniably from a proven and substantially developed field.

[4] In their exceptions to the initial decision, the royalty owners argue that this Commission is barred by the doctrines of *res judicata* and collateral estoppel from holding these transactions to be jurisdictional.[5] The FPC previously rejected those contentions and we continue to do so. We cannot be bound by the conclusion drawn by the FPC in the *Webb-Turner*[6] proceeding. This Commission has a continuing obligation to regulate sales which Congress has declared to be within

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[4] The sellers in negotiating the initial contracts had control over all incidents of sale which a conventional seller-producer, as opposed to a landowner-royalty owner, would have. These included the ability to contract of the quantity to be sold, the price to be paid, the identity of the purchaser and whether it shall be sold in interstate or foreign commerce. In initially contracting for a price for gas, the sellers reserved the right to redetermine the price after the initial contract period. They exercised this right which resulted in an arbitrated finding of prices for the gas in excess of applicable FPC ceiling prices. In stating that the arbitrators found that the contracts provided for prices higher than the FPC ceiling prices, we in no way imply that that result is consistent with applicable law or with the intent of the parties at the time the agreements were negotiated.

[5] Respondents also claim that this case is similar to *Texas Gas Transmission Corporation*, Docket No. CP77-612, Findings and Order After Statutory Hearing Issuing Certificate of Public Convenience and Necessity and Granting Petition to Intervene (May 10, 1978, 3 FERC ¶ ____), in which we found that a sale of gas reserves in place did not constitute a jurisdictional sale. *Texas Gas* is inapposite. The sale in *Texas Gas* involved reserves where the magnitude of reserves was unknown. And more importantly, the purchase price was not tied to the level of any future production or to the magnitude of reserves ultimately discovered. In this case, the purchase price was tied directly to the level of future production.

[6] *Webb-Turner*, Opinion No. 642, 49 FPC 17 (1973).

the Commission's jurisdiction. The Commission cannot waive that jurisdiction.[7] The producers, in this case, have no right to continued non-regulation.[8] And the producers can show no harm from relying on the FPC's decision in the *Webb-Turner* proceeding.

[4] Moreover, the *Webb-Turner* proceeding arose in a different context. It involved primarily issues of wheher to grant the *Webb-Turner* parties permission to abandon sales to El Paso, whether to grant El Paso a certificate to operate the facilities involved in those sales, and what costs related to the gas in question were properly includable in El Paso's cost-of-service. In *Webb-Turner*, the FPC did not directly decide that the lease-sale transactions were non-jurisdictional. Rather it found that it would not impose a *Rayne*-type remedy in that case. Although in so doing the FPC, in essence, indicated that it considered the lease-sales not to be jurisdictional, in view of more recent events there can be no dispute that the FPC's rather oblique ruling was based on less than a complete record and was reached under substantially different circumstances. In light of the increasing burden of consumers of non-regulation of these lease-sale transactions, the FPC was compelled to thoroughly examine these lease-sales to determine whether they are in fact jurisdictional. Prior to the price redetermination, payments were of less regulatory interest to the Commission. After redetermination, when regulatory interest in these leases was greater, changes in fundamental facts necessitated a thorough review of the jurisdictional issue. Additionally, this Commission has been directed by the Fifth Circuit to decide whether the subject lease-sale contracts are sales of natural gas for resale in interstate commerce as defined

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[7] *Brooklyn Union Gas Co.* v. *F.E.R.C.*, 627 F.2d 462 (D.C. Cir. 1980), at 7.

[8] *Nantahala Power and Light Co.* v. *F.P.C.*, 384 F.2d 200 (4th Cir. 1967); *Connecticut Light and Power Co.* v. *F.P.C.*, 557 F.2d 349 (2nd Cir. 1977).

by the Natural Gas Act.[9] For these reasons, the *res judicata* and collateral estoppel arguments cannot stand.

The royalty owners have requested oral argument. They point to the magnitude of the briefs, the lengthy record, and the factual and legal complexity of the issues as reason for oral argument. The case has been well briefed and we feel that oral argument is unnecessary for a thorough review and resolution of the case. Therefore, oral argument will be denied.

[5] Having found that the subject lease-sale agreements are sales of natural gas as defined by the Natural Gas Act, the remains to be decided what remedies should be adopted for past and future periods. Numerous questions remain as to what remedies are available and what action or combination of actions should be taken to insure that consumers are afforded the "complete, permanent and effective bond of protection from excessive rates and charges"[10] contemplated by the Natural Gas Act. These issues were previously discussed by the FPC in its order issued in these dockets on June 3, 1977 58 FPC. However, the FPC later phased the proceeding and deferred the remedy issues until the jurisdictional issue had been decided. This case shall be remanded for hearing and decision of the remaining issues including those set forth in the order of June 3, 1977. The basic issues to be addressed on remand are (1) whether and if so to what extent were the payments made by El Paso, Northwest and PNW to the overriding royalty owners excessive and therefore unlawful, (2) what if any amounts should be required to be refunded by the royalty owners to El Paso and Northwest and flowed through by them to their jurisdictional customers, and (3) what level of royalties should be approved for the future?

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[9] *Tenneco Oil Co.* v. *F.E.R.C.*, 580 F.2d 722, 724 (5th Cir. 1978).

[10] *Atlantic Refining Co.* v. *P.S.C. of New York* ("CATCO") 360 U.S. 378, 388 (1959).

THE COMMISSION ORDERS:

(A) The initial decision of the administrative law judge is affirmed and adopted.

(B) The motion for oral argument is denied.

(C) A hearing shall be held to determine proper remedies for past and future periods in accordance with the terms of this order.

(D) A presiding administrative law judge to be designated by the chief administrative law judge shall preside at the hearing in this proceeding, with authority to establish and change all procedural dates, and to rule on all motions as provided in the rules of practice and procedure.

3. ALJ'S INITIAL DECISION ON JURISDICTIONAL STATUS OF LEASE SALE AGREEMENTS, *EL PASO NATURAL GAS CO.*, 6 FERC ¶ 63,037 (February 20, 1979)

6 FERC ¶ 63,037

El Paso Natural Gas Company, Docket No. CP74-314; Northwest Pipeline Corporation, Docket No. CP76-327; Sun Oil Company, et al., Docket No. CI77-526

Presiding Administrative Law Judge's Initial Decision on Jurisdictional Status of Lease-Sale Agreements

(Issued February 20, 1979)

[Note: Order affirming Initial Decision and initiating further hearing was issued September 25, 1980, and appears at 12 FERC ¶ 61,297.]

Appearances

Paul R. Connolly, J. Alan Galbraith and *Arthur R. Formanek* for El Paso Natural Gas Company

David K. Watkiss, Jack W. Hanks and *Joseph T. Casey* for Northwest Pipeline Corporation

Gordon Gooch and *Charles M. Darling, IV* for Tenneco Oil Company, Continental Oil Company, American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company, and Mr. & Mrs. Morris Mizel

Michael J. Henke and *Mary Jane Reynolds* for Union Oil Company of California

Craig W. Hulvey for Mobil Oil Corporation and Getty Oil Company

George Mickum, Steven H. Brose and *Edward Leahy* for Atlantic Richfield Company

Leo J. Hoffman for Sun Oil Company (Delaware)

John L. Williford and *Larry Pain* for Phillips Petroleum Company

R.H. Landt for Amoco Production Company

Terry R. Barrett and *Stanley L. Cunningham* for F.H.N., Ltd.

William B. Browder, Jr. for W. Watson LaForce, Jr., *et al.*

J. O. Terrell Couch for Robert Beamon, *et al.*

Sherman S. Poland and *Bernard A. Foster, III* for William G. Webb, *et al.*

John S. Fick and *Thomas D. Clarke* for Southern California Gas Company

Shirley A. Woo, Malcolm Furbush, and *Peter Hanson* for Pacific Gas and Electric Company

Edwyn R. Sherwood, Henry E. Brown, and *Joel L. Greene* for Colorado Interstate Gas Company

Bruce R. Debolt and *John H. Socolofsky* for the Oregon Public Utility Commissioner

Radovan Z. Pinto for the People of the State of California and the California Public Utilities Commission

Richard E. Kelly for the Staff of the Federal Power Commission and the Staff of the Federal Energy Regulatory Commission.

BENKIN, *Presiding Administrative Law Judge:*

I

These three cases have been consolidated for investigation under Section 5 of the Natural Gas Act.

The focus of the inquiry is a series of "lease-sale agreements" contracts which transferred ownership of the natural gas reserves underlying a vast amount of acreage in the San Juan Basin.

Most of the San Juan Basin lies in northwestern New Mexico, but a part of it extends northward into Colorado. It is high, semiarid country. The land appears to be unpromising; one

witness described it as "a lot of scenery [and] goat pasture."[1] There was a time when so little was thought of the prospects for the San Juan Basin that most of the land was given to the Indians. Today, we know better: the bowl-shaped sandstone formations that underlie the Basin are permeated by enormous volumes of natural gas. Nearby in the "Four Corners" area are some of the Nation's most abundant deposits of coal.[2] So the Basin, despite its unprepossessing appearance and its isolation from major population centers, is rich.

More than two decades ago, the independent producers who owned the working interests in oil and gas leases covering large tracts of land in the San Juan Basin entered into a series of contracts by which they transferred their leasehold rights to the gas reserves underlying the acreage. The transferees were two corporations. One was El Paso Natural Gas Company (El Paso), a jurisdictional interstate natural gas pipeline. The other, Pacific Northwest Pipeline Corporation (PNW), was soon to become a jurisdictional natural gas pipeline. Under the so-called lease-sale agreements, the interest owners reserved the right to receive certain payments — termed "overriding royalties" — determined by multiplying a specified unit sum by the volume of gas (in Mcf) that the pipelines extracted from the acreage.[3] In time, each royalty would escalate until it would be set at a figure approximating the fair market value of the gas produced.

The question for decision in this proceeding, aspects of which have previously been litigated before a Federal District Court, is whether the lease-sale agreements constituted sales of natural gas for resale in interstate commerce. If, as a matter of law,

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[1] Tr. 337.

[2] See *Chemehuevi Tribe of Indians* v. *F.P.C.*, 420 U.S. 395, 397 n.3 (1975).

[3] In some of the agreements, the overriding royalty payments defrayed the pipeline's obligation to make a "production payment" for gas extracted.

they were, it follows that the agreements have been subject to the regulatory jurisdiction of the Commission under the Natural Gas Act.[4] The principal consequence of a determination that the lease-sale agreements were jurisdictional sales of natural gas would be a holding that the provisions of the agreements which purported to obligate the pipeline-buyers to pay the producer-interest owners amounts (whether or not denominated royalties) exceeding the FPC/FERC-established ceiling prices for gas of the vintages involved were, to that extent, illegal. From such a holding it might also follow that a large portion of the huge sums paid for gas produced under the agreements may have to be refunded and may eventually find its way back into the pockets of ratepayers in California and the Pacific Northwest from whom the funds were exacted in the first place.[5]

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[4] See § 1(b) of the Act, 15 U.S.C. 717(b). At the time this proceeding was begun, the "Commission" in question was the Federal Power Commission. The Federal Power Commission was abolished and was replaced by the Federal Energy Regulatory Commission, which assumed most of the FPC's jurisdiction, under the Department of Energy Organization Act, 42 U.S.C. 7101-7352. The DOE Organization Act took effect on October 1, 1977. This proceeding is continued before the new Federal Energy Regulatory Commission pursuant to §§ 402(a) and 705(b) of the DOE Organization Act, 42 U.S.C. 7172(a), and 7295(b).

[5] The parties have not had the opportunity to submit briefs or arguments on the effect of a holding that the agreements are jurisdictional upon the pricing of the gas under the Natural Gas Policy Act of 1978. Hence, that question will not be dealt with in this decision. Another question that will not be considered in this decision is the matter of criminal liability under Section 21 of the Natural Gas Act, 15 U.S.C. 717t, in the event the Commission determines that the lease-sale agreements constituted unlawful (because uncertificated) jurisdictional sales at above-ceiling prices. Early in the proceeding, Commission Staff Counsel expressly disclaimed any intention on the Staff's part to consider this case for reference to the Department of Justice. Tr. 69.

In order to dispose of the issues, the Commission must necessarily undertake a substantial exercise in historical detective work. In addition, despite the existence of several definitive judicial pronouncements on the subject, from the Supreme Court and elsewhere, the Commission must apply some still-nascent legal principles.

II

This investigation proceeding was instituted by an order of the Federal Power Commission issued on June 3, 1977, 58 FPC 2181, exactly three years after El Paso had filed a complaint asking the Commission to undertake the investigation.[6] Part of the three-year delay was occasioned by the Commission's decision, announced on April 8, 1976, 55 FPC 1677, to defer action upon the complaint pending disposition of litigation then going forward in the United States District Court in Midland, Texas, involving issues identical to those raised by El Paso's complaint to the Commission.[7] The District Court suit came to an end on January 27, 1977.[8]

According to the Commission, the primary question to be determined in this investigation proceeding is whether the "lease-sale" agreements between the pipelines and various owners of working interests in acreage in the San Juan Basin constitute jurisdictional sales of natural gas for resale within

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[6] *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.*, Order Instituting Show Cause Proceeding, Ordering Filing of Evidence and Ordering Hearing, issued June 3, 1977 (hereinafter cited as Order Instituting Proceeding).

[7] See *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al*, Order Deferring Action on Request to Show Cause, Denying Motions and Permitting Intervention, issued April 8, 1976. There is, so far as the record shows, no explanation for the almost two-year delay between the filing of the complaint and issuance of the April 8, 1976 order.

[8] See n. 19, *infra*.

the meaning of Section 1(b) of the Natural Gas Act as it was construed in *Rayne Field*[9] and the progeny of that case.

After El Paso filed its complaint, Northwest Pipeline Corporation (Northwest) filed a petition for leave to intervene in the proceeding. Northwest, like El Paso a jurisdictional interstate natural gas pipeline, is the successor in interest to the lease-sale agreements that were executed by PNW in the 1950's and that eventually came into Northwest's hands by virtue of a court-ordered divestiture.[10] In its April 8, 1976 order, the Commission directed that Northwest's intervention petition would be treated as a § 5 complaint and would be given its own docket number. Thereafter, in the June 3, 1977 order instituting this proceeding, the Commission joined as respondents in the proceeding the interest owners who were parties to the El Paso lease-sale agreements (sometimes called GLAs) and the interest owners who were parties to the lease-sale agreements (denominated PLAs) that had made their way into the hands of Northwest.[11]

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[9] *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392 (1965).

[10] In 1957, after PNW entered into various lease-sale agreements, El Paso acquired all of the outstanding stock of PNW. Two years later, PNW was merged into El Paso, and all of PNW's assets, including its interests under the lease-sale agreements, became part of the Northwest Division of El Paso. After a decade of antitrust litigation, necessitating five separate opinions by the Supreme Court of the United States, El Paso was forced to divest itself of the PNW assets. (*California-Pacific Utilities Co.* v. *United States*, 410 U.S. 962 (1973), *aff'g United States* v. *El Paso Natural Gas Co.*, 358 F. Supp. 820 (D. Col. 1972); *Utah Public Service Comm'n.* v. *El Paso Natural Gas Co.*, 395 U.S. 464 (1969); *Cascade Natural Gas Corp.* v. *El Paso Natural Gas Co.*, 386 U.S. 129 (1967); *United States* v. *El Paso Natural Gas Co.*, 376 U.S. 651 (1964); *California* v. *F.P.C.*, 369 U.S. 482 (1962).

[11] "GLA" means "Gas Lease Agreement" and is the designation given by El Paso to the lease-sale agreements made with El Paso. El Paso designated each of the lease-sale agreements it acquired fron

The Commission also noted that some four years earlier it had issued an opinion which dealt with the question whether certain of the lease-sale agreements were jurisdictional sales of natural gas. In that case, *William G. Webb, et al.* (Opinion No. 642),[12] the Commission had authorized certain of the interest owners—known as the Webb-Turner parties—to abandon conventional sales to the interstate market in order to consummate their contracts to make lease-sales of their acreage to El Paso. Both the Commission Staff and the State of California had argued that the lease-sales themselves were jurisdictional under the *Rayne Field* doctrine. The Commission had distinguished *Rayne Field* and rejected that argument.[13] The June 3, 1977 order initiating the instant proceeding expressly made the interest owners who were parties to the *Webb, et al.*, Opinion No. 642 case parties to this case. The Commission said that it wanted to review the holding in Opinion No. 642 in light of today's changed circumstances, holding that the doctrine of *res judicata* did not preclude relitigation of the jurisdictional issue decided in that Opinion.[14]

PNW as a "PLA," which stands for "Pacific Lease Agreement." The PLAs are now owned by Northwest, of course, and Northwest has continued to use the El Paso terminology to designate the contracts.

[12] 49 FPC 17 (1973).

[13] *Id.* at 25-26.

[14] In its Order Instituting Proceeding, the Commission said that the *Webb* decision "did not consider at that time whether the continuing production payment itself was a sale." 59 FPC 1209 at 1214-1215. As the Commission acknowledged in its July 29, 1977 order on rehearing, however, that statement was incorrect. Nevertheless, the Commission on rehearing adhered to its determination to reconsider the jurisdictional holding in *Webb* in light of "the changed circumstances of today" and to its conclusion that "The doctrine of res judicata does not apply where changed circumstances appear." *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.*, Order on Rehearing, Ruling on Motions for Deferral of Proceedings, Granting Motion to Designate Additional Parties, Granting Late Interventions and Granting Motion to Delete Respondent, issued July 29, 1977, 59 FPC 1214-1215 (hereinafter cited as Order on Rehearing).

The event which precipitated the entire controversy was a dispute between El Paso and Sun Oil Company, the owner of the "overriding royalty" interest under GLA 61. That agreement provided for redetermination of the rate of the per-Mcf overriding royalty payable to the interest owner at specified intervals; after 15 years, the royalty was to be a rate fixed by mutual agreement of the parties (but not less than ten cents per Mcf). In the absence of agreement between the parties, the contract provided for determination of the royalty rate by a board of arbitrators who "shall base their decision on the then value of such gas at the well head."[15] In 1973, after the 20-year price-redetermination point arrived, El Paso and Sun were unable to agree on a mutually-acceptable royalty rate. At Sun's insistence, the dispute was submitted to a board of arbitrators. The board agreed with Sun's contention that, under GLA 61, it was entitled to the full market value of the gas at the wellhead, and that the operative standard for establishing market value was the going wellhead price for natural gas in the intrastate market. The board's decision, issued in 1973, rejected the contention that the market value of the GLA 61 gas should be equal to the lower FPC-established rate for interstate sales of gas of the same vintage. The board set the royalty rate for El Paso's payments to Sun at 40 cents per Mcf.[16]

Upon learning of the Sun award, other GLA and PLA interest owners demanded redetermination of the rates applicable to their per-Mcf overriding royalties, under either rate redetermination or favored nations clauses in their lease-sale

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[15] Exh. 22, p. 9.

[16] The respondents assert that the arbitrators' award of 40 cents per Mcf was substantially less than the prevailing intrastate price in the vicinity; 55-60 cents per Mcf. See Respondents' Initial Brief, p. 25. It is nonetheless conceded that the FPC-regulated interstate price for flowing gas of similar vintage was 24 cents per Mcf. See Complainants' Proposed Findings of Fact (hereinafter "CPFF") No. 193, p. 61; Responses of Designated Respondents to Complainants Proposed Findings of Fact (hereinafter "RCPFF"), No. 193, p. 101.

agreements.[17] El Paso's response to these demands was to file four separate lawsuits in U.S. District Court against some interest owners under the GLAs. The actions, which were eventually consolidated and transferred for trial to the District Court for the Western District of Texas, sought declaratory judgments that the lease-sale transactions were in reality jurisdictional natural gas sales which had to be the subjects of FPC-issued certificates of public convenience and necessity before any overriding royalties could lawfully be collected. In addition, El Paso sought to enjoin any interest owner from following Sun's lead and seeking an arbitration award. On June 3, 1974, having filed its complaint with the Commission, El Paso moved in the District Court for a stay of proceedings and for reference of the suit to the Commission. The Court withheld decision on the motion (and, in fact, simply never ruled on it). The District Court did, however, issue an order on August 1, 1974, permitting Northwest to intervene in the litigation. It did so because after the suits were instituted, Northwest succeeded to El Paso's interest in one of the lease-sale agreements on which El Paso had sued.[18]

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[17] The typical favored nations clause provided that the interest owner would receive the highest overriding royalty rate paid by the pipeline-producer for gas produced under any lease-sale agreement covering acreage located within 200 miles of the interest owner's acreage.

[18] See n. 10, *supra*. The lease-sale agreement was PLA 13 with Mobil Oil Corporation as the interest owner. Northwest acquired El Paso's rights under PLA 13 on February 1, 1974. After having made the acquisition, Northwest not only intervened in El Paso's suit in order to assert its interests under PLA 13, but also sought to join as parties to the suit the interest owners who were parties to the remaining PLAs which were not involved in El Paso's action, so that it could obtain an adjudication of its rights and liabilities under the PLAs. The District Court, however, refused to permit joinder of the remaining independent producers.

On January 27, 1977, after a 26-day trial and four days of oral argument, the District Court issued its decision.[19] The Court held that the lease-sale transactions were not sales of natural gas for resale within the meaning of Section 1(b) of the Natural Gas Act and, consequently, were not subject to the regulatory jurisdiction of the Commission.[20] The District Court thereupon dismissed the suits for lack of subject-matter jurisdiction.[21] The judgment of the District Court was appealed to the United States Court of Appeals for the Fifth Circuit.[22] The Fifth Circuit was also the venue of petitions filed by a number of respondents, seeking immediate judicial review of the Commission's order of June 3, 1977 sending this case to hearing and its July 29, 1977 order denying rehearing of the June 3 order.[23] The Court of Appeals consolidated the various cases for argument and, on September 6, 1978, issued an order deferring its ruling on all of the appeals pending the Commission's decision in this proceeding.[24]

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[19] *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 426 F. Supp. 963 (W.D. Tex. 1977).

[20] *Id.* at 970.

[21] *Id.* at 971.

[22] *El Paso Natural Gas Co.* v. *Sun Oil Co.*, No. 77-1762.

[23] *Tenneco Oil Co.* v. *F.E.R.C.*, No. 77-2613, *et al.*, 580 F.2d 722 (5th Cir. 1978).

[24] Shortly after the District Court rendered its decision, Northwest entered into settlement agreements with the PLA interest owners. The agreements mirrored the terms of settlement agreements which El Paso and the GLA interest owners had executed in October 1974. Both pipelines agreed, during the pendency of litigation about the jurisdictional status of the lease-sale contracts, to pay overriding royalties at a rate keyed to, but slightly less than, the regulated ceiling price for new San Juan Basin gas. The outcome of this proceeding (including judicial review of the Commission's action) is to control the rights of the interest owners to retain the funds. In an order issued February 16, 1977, 57 FPC 989, the Commission permitted El Paso to pass through to its customers the cost of the higher

Meanwhile, the administrative hearing went forward. At first, plans were made for trial of all issues, including the question of the remedy that would be appropriate if the lease-sale agreements were ultimately held to constitute jurisdictional wellhead sales of natural gas. In an order issued February 13, 1978, 2 FERC ¶ 61,124, however, the Commission directed that the proceeding should be phased, so that the question of the Commission's jurisdiction over the agreements would be litigated and decided first, with the remedial issue pretermitted until after the jurisdictional question was decided.[25]

The hearings on the jurisdictional issue got underway on May 2, 1977. At an early stage of the proceedings, all parties concerned agreed to stipulate that issues once litigated in the District Court in Midland would not be retried, and that the evidentiary record in the District Court case would be received in evidence in this proceeding and would be the basis for the Commission's disposition of the jurisditional issues between the parties to this proceeding who were also parties to the Midland case. This stipulation saved a great deal of time and effort. Nevertheless, the hearing into the disputes which were not the subject of the Midland litigation consumed 19 days of hearing sessions beginning on May 2, 1978 and ending on June 6, 1978. All parties filed proposed findings of fact and responses to proposed findings of fact on July 3, 1978 and July 25, 1978, respectively. Simultaneous initial briefs were filed on September 11, 1978, and reply briefs were filed on September 29, 1978.

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overriding royalty payments. As of the date this record closed, Northwest had been authorized two rate increases, of $27 million and $34 million, to recover its expenditures for increased overriding royalties.

[25] *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.*, Order Granting Motion for Phasing of Proceedings and Deferral of Procedures Concerning Remedy, issued February 13, 1978.

III

The first of the lease-sale agreements in the San Juan Basin was GLA 32, entered into in 1950 between El Paso and Delhi Oil Corporation (Delhi). Examination of the history of that transaction is basic to an understanding of why the parties to that agreement, and the balance of the lease-sale agreements, chose to do business in the hybrid lease-sale format rather than through conventional wellhead-sale contracts.

El Paso had been interested in the San Juan Basin as a source of gas supply for several years before GLA 32 was consummated. To supply its first pipeline to California, El Paso had relied almost exclusively on casinghead gas produced in the Permian Basin. This source of supply proved to be unsatisfactory. Casinghead gas, being a by-product of oil production, was produced only as oil was produced. The schedule for oil production was, to a large extent, a function of state prorationing orders and the market's demand for petroleum products, chiefly motor vehicle gasoline. Oil production tended to be most plentiful at the beginning of each month, when producers sought to meet their "allowables" and during the warm weather months, when highway travel was heaviest. These peak periods of oil—and casinghead gas—production did not coincide with the times when demand for natural gas was high in El Paso's markets.

In addition, there simply was not enough natural gas available to El Paso from its Permian Basin sources. In the mid-1940's, it became clear to the pipeline and the California utilities it served that the rapidly expanding California market's demand would soon outstrip El Paso's existing dedicated reserves. The Federal Power Commission, too, was putting pressure on El Paso to secure dedication of new and substantial reserves of dry gas, free from the vagaries of oil production.

As a result of these factors, El Paso undertook a search for a large dry gas supply. The search eventually centered in the San Juan Basin, where gas had first been produced, though not in commercial quantities, as early as the 1920's. The San Juan

Basin's relative proximity to El Paso's California market made it particularly attractive to the pipeline.

Delhi, an independent producer, owned substantial reserves of natural gas in the Barker Dome Field of the San Juan Basin. Like other independent producers operating in the Basin, Delhi was unable to market its gas because no interstate pipeline had reached the Basin, and local demand could not absorb the existing potential supply. El Paso proposed to fill the need for an interstate pipeline connecting the Basin to major metropolitan areas. On August 25, 1947, it filed an application with the FPC, seeking a certificate of public convenience and necessity for construction and operation of a pipeline from the San Juan Basin to a point on the Arizona-California border near Needles, California.

Delhi and El Paso executed a gas-purchase contract dated May 1, 1948. Under the contract, Delhi was to sell and El Paso agreed to purchase up to 100,000 Mcf of natural gas per day for a period of 25 years, and from year to year thereafter, at a base price of ten cents, with a specified escalation of the price of each two and one-half years for the first 15 years of the contract.[26] After the first 15 years, and at five-year intervals thereafter, the price would be set at the fair market value of the gas at the wellhead. It is a measure of the times that the parties set a 13-cent-per-Mcf floor on the fair-market-value figure to be employed under this redetermination clause.[27]

By its terms, the contract would not become operative until two events occurred. Both involved the Federal Power Commission. First, El Paso would have to obtain favorable action from the FPC upon its application for certification of its pipeline project, an application which it had filed nearly nine months earlier. Second, Delhi would have to obtain from the

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[26] Exh. 40 EP 2, pp. 15, 17, 25. For the first ten years of the contract, the price was to escalate one-half cent per year; the price was to escalate one cent per year during the remaining five years.

[27] *Id.* at 25.

Commission a ruling that its performance under the contract would not make the company a jurisdictional natural-gas company.[28]

On May 19, 1948, El Paso and Delhi entered into a second contract which called for both of them jointly to construct, own, and operate the pipeline from the Basin to California that was the subject of El Paso's pending application to the FPC. Thereafter, on June 30, 1948, the San Juan Pipe Line Company, a newly-formed corporation owned by El Paso and Delhi, filed an application with the Commission for a certificate authorizing it to construct, own, and operate a pipeline from the San Juan Basin to California.

The plan, under which the parties would jointly own and operate the pipeline that would, in turn, enable them to market a supply of natural gas to be sold under a relatively conventional gas sale contract, came a cropper, however. The critical problem was Delhi's inability to secure from the Commission a declaratory order, ruling that its performance under the contracts would not subject it to regulation by the Commission under the Natural Gas Act. Three times it sought such a ruling, and three times the Commission refused to issue one.[29]

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[28] *Id.* at 3-5. The contract also required Delhi, *inter alia*, to commit its Barker Dome acreage to the substantial performance of its contractual obligations, to drill wells (within the limits of state spacing restrictions) sufficient to supply the contract volumes of gas, to gather and treat the gas (reserving to Delhi the right to remove hydrocarbons other than methane), and to deliver pipeline-quality gas to a central point on the proposed pipeline. In addition to the above-described pricing provisions, the contract had a favored nations clause.

[29] *Delhi Oil Corp.*, 8 FPC 613 (1949); *Delhi Oil Corp.*, 7 FPC 1025 (1948); *Delhi Oil Corp.*, 7 FPC 958 (1948). The problem, in those pre-*Phillips* days, evidently inhered in Delhi's participation in the pipeline-ownership-and-operation project. In the two later applications, Delhi proposed to restrict, though not completely terminate, its participation and interest in the San Juan Pipe Line Company. The Commission, nevertheless, apparently felt that an independent

As a result, El Paso and Delhi abrogated their contract to construct the pipeline and entered into a new and substantially modified gas-purchase contract. Under the new gas-purchase contract, dated February 4, 1949, El Paso was entitled to call upon Delhi to supply up to 150,000 Mcf of gas per day to meet its peak loads. The second contract, like the first, was conditioned upon an FPC determination that Delhi would be free of regulation under the Natural Gas Act.[30] This time the pipeline to California was to be constructed, owned, and operated by El Paso, without any participation or assistance from Delhi. These terms were evidently satisfactory to the Commission, for on March 10, 1949, it issued an order in which it determined that Delhi would not become a regulated natural gas company by virtue of its performance under the second gas-purchase contract.[31]

While all of this was going on, the larger question of the amenability of independent producers to regulation under the Natural Gas Act was being loudly debated in several forums. There is no doubt about the fact that Delhi, like many other independents, was concerned about the prospect of FPC regulation and was anxious to take whatever steps were feasible to avoid the spectre of jurisdictional status.

In June of 1947, the Supreme Court of the United States, noting that the Commission had not asserted jurisdiction over wellhead sales *per se*, had commented: "We express no opinion

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producer's affiliation with, and co-ownership of, a jurisdictional pipeline could render the producer jurisdictional. To Delhi, a holding that it was jurisdictional would bring down upon it two undesirable consequences: cost-of-service treatment of its gas sales and a regulated rate of return. Once Delhi divested itself of all interest in the pipeline company, however, the law as it then existed placed no impediment in the path of the Commission's issuance of a nonjurisdictional status determination.

[30] Exh. 40 EP 6, pp. 7-8, 22-23.

[31] *Delhi Oil Corp.*, 8 FPC 750 (1949).

as to the validity of the jurisdictional tests employed by the Commission in these cases."[32] Since the issue in the *Interstate* case was the Commission's jurisdiction over a sale by a pipeline, not its jurisdiction over an independent producer's sale, it was unusual and ominous for the Court to reach out to comment on the jurisdictional status of wellhead sales by such producers. Soon thereafter, the Commission issued Order No. 139,[33] adding to its General Rules a new Section 2.54, which purported to exempt wellhead sales by independent producers to interstate pipelines from FPC jurisdiction.

Presumably, the Commission's issuance of the new Section 2.54 was designed to eliminate any doubt about the status of independent producers that may have been engendered by the Supreme Court's comment in the *Interstate* case. The matter would not die that readily, however: On October 28, 1948, the Commission launched an investigation to determine whether Phillips Petroleum Company, an independent producer, had become a jurisdictional natural-gas company by virtue of its wellhead sales of natural gas to an interstate pipeline.[34] In addition, on May 11, 1949, two months after Delhi received its favorable ruling from the Commission, Chairman Nelson Lee Smith of the FPC sent a letter to Arizona Senator Carl Hayden, in which Smith indicated that Delhi's proposed wellhead sale of natural gas to El Paso might subject Delhi to regulation by the Commission.[35] At this time, there was pending in Congress a bill which would have amended the Natural Gas Act to grant independent producers specific legislative

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[32] *Interstate Natural Gas Co.* v. *F.P.C.*, 331 U.S. 682, 690 n.18 (1947).

[33] 12 F.R. 5585 (1947).

[34] *Phillips Petroluem Co.*, 7 FPC 983 (1948). Between the date Section 2.54 was issued and the date the *Phillips* investigation began, Commissioner Richard Sachse had resigned and had been replaced by Commissioner Thomas C. Buchanan.

[35] Exh. 40 EP 1720.

exemptions for their wellhead sales to interstate pipelines, in effect enacting as a statute Section 2.54 of the Commission's General Rules.

After it became aware of Chairman Smith's letter to Senator Hayden, Delhi sought clarification of its status from the Commission.[36] The Commission replied that, inasmuch as Delhi's status turned on the answer to a question of law, *i.e.*, the legal effect of Order No. 139, promulgating Section 2.54 of the Commission's Rules, "The Commission is unable, in the circumstances, to express a conclusive opinion as to whether you will or will not be subject to regulation under the Natural Gas Act by virtue of proposed sale of natural gas to El Paso."[37] Chilling words indeed!—indicating that the Commission's confidence in the legal validity of § 2.54 was beginning to ebb. This development, coupled with other rapidly moving events on the jurisdictional front (*e.g.*, the ongoing *Phillips* investigation), caused Delhi to seek the advice of counsel on other ways to carry out the objectives of its agreement with El Paso without subjecting itself to the risk of regulation under the Natural Gas Act.

Delhi's counsel in Dallas sought the advice of Charles V. Shannon, a Washington lawyer specializing in FPC law and the Commission's one-time General Counsel. In a letter of December 1, 1949, Shannon expressed the opinion that if Delhi, instead of going through with its then-pending wellhead sale contract with El Paso, were to transfer its Barker Dome reserves through a sale of the underlying leases, the transaction would be non-jurisdictional and would not make Delhi subject to regulation by the Federal Power Commission.[38] In light of

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[36] *Id.*

[37] Exh. 40 EP 1721.

[38] Exh. 40 EP 22. Shannon's opinion was based upon the then-recent decision of the Supreme Court in *F.P.C.* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949), holding that the Natural Gas Act did not apply to the transfer of leases by an interstate pipeline to a production company. It should be noted that Shannon's opinion was

Shannon's opinion and the confusion surrounding the legal status of independent producers, the parties decided to renegotiate and recast the second gas-purchase contract in the form of a lease-sale agreement. Under the lease-sale format, Delhi would sell its gas leases covering the Barker Dome acreage to El Paso, and El Paso would undertake the production of natural gas from the acreage. Delhi would receive compensation for the gas in an amount roughly equivalent to the per-Mcf price it would have received under the gas-purchase contract, minus El Paso's production costs.

The most significant factor in the arrangement was this: the lease-sale format was developed specifically for the purpose of putting the independent producer and the pipeline in about the same economic positions they would have enjoyed under a conventional wellhead gas sale contract. From the standpoint of the parties to the first lease-sale agreement, the primary purpose—and perhaps the sole purpose—of using that format rather than a conventional wellhead gas sale contract was to avoid the possibility that independent producers who sold their gas to interstate pipelines under such a contract would be held to be natural-gas companies subject to the Federal Power Commission's regulatory jurisdiction.

El Paso and Delhi abrogated the second gas-purchase contract on January 27, 1950. On the same day, they entered into a lease-sale agreement, which El Paso later designated GLA 32. The agreement provided that El Paso would pay to Delhi an "overriding royalty" on all gas produced from the Barker Dome acreage. The amount of the payment was to be five cents per Mcf for the first five years, six cents per Mcf for the next five years, and seven cents per Mcf for the ensuing five years;

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rendered five years before the Supreme Court held, in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954), that wellhead sales by independent producers were jurisdictional and 16 years before the *Rayne Field* case, *supra*, held that the sale of a lease may be the legal equivalent of a jurisdictional sale of natural gas.

thereafter, the seven-cents-per-Mcf price would remain in effect until cumulative production taken from the acreage by El Paso reached 600 Bcf, after which the "royalty" would be equal to the fair market value of the gas (but not less than 7¢ per Mcf).[39] Delhi reserved all rights to any oil production. The agreement called for El Paso to make a substantial cash down payment, which could be increased or decreased in the future depending upon the parties' recalculation of the gas reserves underlying the acreage. El Paso was entitled to take a maximum of 110,000 Mcf per day; under the take-or-pay clause, it was obligated to take a minimum of 60,000 Mcf per day.[40] The lease-sale agreement, like its predecessor contracts, was contingent upon FPC issuance of the certificate to construct a pipeline and transport San Juan Basin gas to California markets. That contingency was satisfied on July 4, 1950, when the Commission issued the certificate to El Paso.[41] One year later, in July 1951, El Paso began the transportation to California of natural gas produced from the Barker Dome Field.[42]

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[39] Exh. 40 EP 29.

[40] *Id.* at 9-10. Under a "take-or-pay" clause, the putative lessee was obligated to pay for a specified minimum volume of gas production from the acreage, regardless of whether that volume of gas was actually produced and taken into the pipeline. The effect of the clause, in the context of a lease-sale agreement, is to prevent the lessee from shutting in production from the acreage covered by the agreement, thereby limiting its financial obligation and depriving the lessor of revenue.

[41] *San Juan Pipe Line Co.*, 9 FPC 170 (1950).

[42] Congress eventually passed the bill exempting well-head sales by independent producers from Federal regulation under the Natural Gas Act. On April 15, 1950, President Truman vetoed the measure. Shortly thereafter, on July 11, 1950, the Commission issued Order No. 154, 15 F.R. 4633 (1950), rescinding Section 2.54 of its General Rules on the ground that the administrative exemption of wellhead sales by independent producers to interstate pipelines was inconsistent with the Natural Gas Act.

IV

One of the most bitterly contested issues in this case concerns the extent to which the gas-producing potential of the San Juan Basin was fully known at the time El Paso began its program of acquiring leases in the Basin. Although a great deal of time and attention has been devoted to the geology of the San Juan Basin and its prospects from a business and economic standpoint, the essential facts can be summarized in relatively brief compass.

Large volumes of natural gas underlie the San Juan Basin, and geologists and petroleum engineers were generaly aware of this fact as early as 1950, when GLA 32 was signed.[41] The gas occurs principally in three sandstone formations: 1. The Pictured Cliffs formation, the shallowest of the three; 2. The Mesaverde formation, the primary focus of developmental activities, consisting of two distinct pay sands, the Cliff House and the Point Lookout, separated by the non-gas-bearing Menafee formation; and 3. The Dakota formation, the deepest of the three.[44] The three formations share certain similarities. All are of varying depths and thicknesses. Each of the formations consists of blanket, gas-bearing sands which are deepest towards the center of the Basin and outcrop progressively at the Basin's perimeter.[45] All of the gas-bearing formations are characterized by relatively low porosity and permeability.[46] Because of the low porosity and permeability of the pay sands, it was well known that the gas of the San Juan Basin would be relatively expensive to extract, and that a producer would have to wait longer to recover his investment in a San Juan

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[41] See *e.g.*, Exh. 40 EP 1920.

[44] Exh. 38, III J.A. 552a-554a, 557a.

[45] Exh. 38, III J.A. 554a; Exh. 40 EP 1905(A)(2), p. 3; 40 EP 1905(F)(1), pp. 3-4; 40 EP 1905(F)(1), pp. 4-5.

[46] Exhs. 38, III J.A. 553a-554a, 576a; 40 EP 1905(A)(2), p. 4; 40 EP 1920, p. 119.

Basin well than he would have to wait for payout from a well drilled elsewhere. Counterbalancing these factors was the blanket nature of the sands, a phenomenon which tended to assure that gas would be encountered at virtually any location.[47]

In the early 1950's, DeGolyer & MacNaughton (D&M), a respected, well-known firm of oil and gas geologists, made numerous studies and evaluations of the natural gas reserves of the San Juan Basin. D&M concluded that reserves of natural gas were available in sufficient quantities to warrant commercial production activities.[48] Using the volumetric method of estimating, D&M expressed great confidence that large volumes of natural gas were available for extraction from virtually all of the San Juan Basin acreage that the firm studied. For example, in a January 1, 1950 report presenting "an estimate of the proved recoverable reserves from the lower Paradox limestone formation in the Barker Creek Gas Field * * * and certain acreage under dedication to El Paso Natural Gas Company,"[49] D&M concluded that—

> This reservoir is estimated to contain 2 trillion 294 billion 272 million cubic feet of gas in place within an area of 45,000 acres.
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> * * * * * *
>
> The indicated original reserve in place per acre for the entire field is 50 million 983 thousand cubic feet per acre.
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> * * * * * *

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[47] A witness for Northwest testified that, having drilled several hundred wells in the Basin, the pipeline had never had a dry hole. Tr. 765.

[48] See, *e.g.*, Exhs. 40 EP 1905(A)(1), (A)(2), (C)(2), (C)(9), (E)(2), (E)(4), (F)(1), (F)(2).

[49] Exh. 40 EP 1905(A)(1), p. 1.

> The remaining gas reserves of the field recoverable to a terminal pressure of 250 psig shut-in wellhead after deducting the cumulative production to January 1, 1950 is 2 trillion 88 billion 743 million cubic feet.
>
> The gas reserve available for pipeline sale after making allowances for miscellaneous field use, treating losses and fuel, recoverable to a terminal pressure of 250 psig shut-in wellhead is 1 trillion 531 billion cubic feet.[20]

This language, it should be noted, pertains to only one set of leaseholds in the Basin. D&M was similarly sanguine about the abundance of proved reserves underlying other acreage that it studied.

The respondents now claim that D&M's use of the "volumetric" method of calculating reserves in place, rather than the more precise "pressure decline" method, resulted in gross overestimates on D&M's part. They also quibble about D&M's use of the term "proved reserves" in the firm's several reports; respondents claim there is a difference between that term as D&M used it and the "proved reserves" that must be present before a sale of a leasehold will be construed as a sale of gas in place under the teachings of *Rayne Field* and its progeny. Both of these contentions are rejected. In the first place, respondents' criticisms are palpably the product of litigation-inspired 20/20 hindsight. So far as this record shows, all of the contemporaneous, knowledgeable, interested persons who reviewed the D&M reports placed complete confidence in their accuracy for the purpose for which they were made; the FPC, for instance, certificated a major new pipeline system based upon the reserve estimates produced by D&M.

In the second place, it is doubtful that either *Rayne Field* or any of the cases that have expounded upon the *Rayne Field* doctrine demand that proven reserves be defined with the hairsplitting nicety upon which the respondents seem to insist. All that *Rayne Field* requires is that the parties know and

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[20] *Id.* at 4-5.

believe there is at least a specified quantity of gas in place upon which they can rely for the purpose of transacting business.

Thirdly, while the volumetric method is admittedly less accurate than the pressure decline method, the difference is not substantial when we are dealing with an area as great, and volumes as large, as those the San Juan Basin presented. Furthermore, the volumetric method of estimating reserves is today, and was then, a sound, generally-accepted technique for estimating gas reserves, especially in a field with little or no production history.[31] This is not, moreover, a case of preferring a faulty methodology over an exact and precise one. As counsel for Atlantic Richfield, one of the respondents, pointed out during the Midland trial, "reserve estimating is at best an inexact science."[32]

Finally, as noted above, the record shows that, contemporaneously with the D&M studies and thereafter, all of the parties acted on the assumption that there were massive quantities of proved reserves underlying the San Juan Basin. The most persuasive point is that, notwithstanding the above-average costs of extracting the San Juan Basin's gas reserves,[33] experienced and knowledgeable businessmen were willing to expend huge sums of money to obtain rights to the gas reserves of the Basin.

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[31] See Exh. 38, IV J.A. 1218a-19a.

[32] *Id.* at 1219a. To which the witness responded, "I think that's a good classification, yes, sir."

[33] Several of the factors that caused the cost of extracting gas from the Basin to exceed the cost of comparable development activities elsewhere in the Southwest have been noted above. There was the low permeability and porosity of its gas-bearing sandstone formations, coupled with the unusually low pressure of the gas reserves. In addition, the relative isolation of the Basin and the lack of a local gas-technology infrastructure, *e.g.*, skilled drillers and equipment suppliers, made the cost of development operations higher than would have been the case in, say, the Permian or Hugoton Basins.

Delhi and other independent producers (some of whom are now before the Commission in this case, taking the view that the Basin was a risky speculation), all successful and profit-oriented business concerns, acquired leases on much of the Basin's acreage and were willing to agree to delay-rental obligations for failure to develop the leases. Delhi had in fact executed two contracts with El Paso, under which it was obligated to make wellhead sales of the reserves underlying its acreage. Although the contracts were aborted, the problem was not a lack of confidence in the estimates of the Delhi reserves. Similarly, El Paso risked the vast sums that went into the construction of the San Juan pipeline on the belief that its acquisitions in the Basin included enough reserves to support that investment. The Commission, too, must have been convinced of the virtual certainty of the reserves; it certificated the pipeline on that basis. And D&M, then as now one of the most prestigious engineering consulting firms in the nation, had staked its professional reputation on its evaluation.

At that time, before the significance of the question for purposes of litigation became known, all of the knowledgeable persons in the field acted upon the assumption that large volumes of proved reserves could be produced from the San Juan Basin. It is too late now to suggest that the contrary was true.

V

As we have seen, use of the lease-sale format as the mechanism for transferring reserves began with GLA 32, which was executed early in 1950. GLA 32, however, is not involved in this proceeding, and is substantially different in content from the El Paso lease-sale contracts that were executed later. The basic terms and conditions that recur again and again in the lease-sale contracts involved in this proceeding first appeared in GLA 47, signed in January of 1952. It seems clear that the contents of GLA 47 set the pattern for the rest of the San Juan Basin GLA contracts. For this reason, it is worthwhile to look into the reasons why GLA 47 came into being.

Once again, the fundamental stimulus was California's seemingly insatiable hunger for natural gas. As the demands of the California market increased, El Paso was once again confronted with the urgency of obtaining new gas supplies in order to maintain its position as California's primary gas supplier. On March 6, 1951, El Paso had filed an application with the Federal Power Commission, seeking a certificate authorizing the transportation of an additional 100,000 Mcf of gas per day from the San Juan Basin to the California border.

By early 1951, Delhi had acquired huge reserves of natural gas in the Blanco-Largo and Kutz Canyon-Angel's Peak Fields of the San Juan Basin, both of which were located to the Southeast of the Barker Dome Field. It was clear to El Paso that, in order to support its pending FPC application to increase its natural gas service, it would have to obtain dedication of the vast Delhi reserves to the El Paso system. This was the case for two reasons. First, the Delhi reserves were uniquely large enough to provide the volumes needed to support the application. Second, the unique strategic location of the Delhi reserves permitted them to be rapidly introduced into El Paso's pipeline system, thereby providing the deliverability that El Paso needed to demonstrate to the Commission.

El Paso at first attempted to purchase the gas from Delhi at the wellhead. It offered an initial base price of 7.33 cents per Mcf plus longevity escalations. Delhi rejected the offer on the ground that the price was too low. El Paso then approached other independent producers in the area, seeking to make wellhead sales contracts. But those producers, aware of El Paso's urgent need for the dedication of new reserves and of Delhi's strong bargaining position, refused to consummate sales to El Paso until the outcome of the negotiations with Delhi became known. Hence, El Paso was forced to deal with Delhi first. Unable to obtain the gas reserves it needed through the medium of conventional wellhead sale contracts, El Paso sought to purchase Delhi's leases in a transaction similar in form to the Barker Dome sale that had taken place in 1950.

After months of hard bargaining, the parties executed the lease-sale agreement now known as GLA 47 on January 18, 1952.[54]

GLA 47 covered leases owned by Delhi in the Blanco-Largo Field of the San Juan Basin. In the contract, Delhi agreed to assign its entire interest in the leaseholds to El Paso, reserving an "overriding royalty" on all gas produced and saved from the subject acreage. The *quantum* of the "overriding royalty" was fixed as follows:

5½¢ per Mcf for the first 3 1/3 years from date of closing.

6½¢ per Mcf for the next 3 1/3 years thereafter.

7½¢ per Mcf for the next 3 1/3 years thereafter.

Not less than 8¢ per Mcf for 1 year thereafter.

Not less than 9¢ per Mcf for 1 year thereafter.

Not less than 10¢ per Mcf thereafter.[55]

The agreement also provided for redetermination of the price after the tenth year and after each ensuing five-year period. If the parties were unable to reach agreement as to the new price, the issue would be settled by arbitration, with the arbitrators fixing the price at the fair market value of the gas at the wellhead (but not less than the minimum figures set forth above). The agreement also contained a favored nations clause.

In addition to its "overriding royalties" on gas production, Delhi also retained substantial rights in other minerals. Delhi reserved a 33 1/3% interest in all liquid hydrocarbons extracted from the acreage, and it had the option to require El Paso to pay the override in kind or in cash at the fair market value of the liquids. Delhi reserved the rights to any oil recovered from the leasehold. Delhi also retained the rights to all gas or other

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[54] The negotiations were conducted by two now-legendary figures in the industry, Clint Murchison, President of Delhi and Paul Kayser, President of El Paso.

[55] Exh. 24, p. 5.

hydrocarbons taken from any formation deeper than the Mesaverde.

The agreement also contained a take-or-pay clause, which required El Paso to pay for a minimum volume of gas production from the leasehold, whether or not it took that quantity.[36] It imposed a number of specific drilling and developmental obligations upon El Paso, such as the obligation to develop the acreage fully down through the Mesaverde and all shallower formations and to drill at least one well on each 320-acre spacing unit during the first five years after execution of the contract. El Paso also undertook complete responsibility for operation of the acreage, including the actual production of gas from it. In the contract, El Paso agreed to pay Delhi for wells located on the acreage at the date of closing. The price was $80,000 for each completed commercial Mesaverde well and $20,000 for each completed commercial Pictured Cliffs well.

El Paso was given the right to reassign acreage to Delhi, and thereby to be relieved of responsibility to develop the acreage, if it appeared that a specific production unit would not produce gas in commercial quantities. In addition, El Paso had the right to reconvey to Delhi any specific well that proved to be unprofitable to operate; Delhi then had the option to continue production from the well, selling the gas to El Paso at the wellhead at the highest price prevailing in the field. Finally, the agreement provided that Delhi had the option to purchase, at El Paso's cost, any oil well El Paso might complete.

The question whether the GLA 47 transaction would render the seller subject to FPC jurisdiction apparently remained

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[36] The clause (Article VII, Section 1) was somewhat ambiguous. It set the take-or-pay quantity at all gas produced from the acreage until total production exceeded 100,000 Mcf per day. Thereafter, El Paso was obligated to take or pay for the greater of 25% of the open flow capacity of all the wells, on the basis of an 80% load factor, but not more than 150,000 Mcf per day, or 100,000 Mcf of gas per day until the acreage was fully developed and 25% of open flow capacity up to 150,000 Mcf per day thereafter. In any event, the minimum daily takes could be averaged out over a one-year period.

uppermost in the minds of Delhi's principals, for they sought another legal opinion on that subject shortly before the agreement was executed. On January 7, 1952, eleven days prior to the signing of GLA 47, Delhi's counsel, Charles V. Shannon, issued another opinion, in which he reiterated his view that consummation of this particular lease-sale agreement would not make the transaction jurisdictional under the Natural Gas Act.[57]

GLA 47 was closed on March 1, 1952. On that date, Delhi assigned its leases and wells to El Paso and El Paso paid Delhi $1,020,941.34 for Mesaverde and Pictured Cliffs wells situated on the acreage covered by the agreement.[58] Shortly after the closing, during March 1952, El Paso began to transport gas produced from the GLA-47 acreage through its interstate pipeline system.[59] Three months later, on June 19, 1952, the Federal Power Commission granted El Paso's application for a certificate authorizing the expansion of its facilities.[60]

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[57] It is significant that Shannon's opinion was issued about a month after the parties had signed a memorandum agreement, dated December 5, 1951, outlining the significant terms of the contemplated lease-sale agreement. They evidently believed that the deal could have been aborted if counsel subsequently advised that there had been a shift in the jurisdictional winds.

[58] CPFF (Complainants' Proposed Findings of Fact) No. 116, p. 43; See also Exh. 24 (Letter from Delhi Oil Corp. to El Paso Natural Gas Co., dated February 29, 1952, re: Delhi-El Paso Trade, pp. 1-4. It should be noted that the parties considered the wells to be sufficiently commercial to fall within the contract requirement that El Paso must pay Delhi only for commercial wells. See Exh. 24, p. 10.

[59] CPFF No. 118, p. 43.

[60] *El Paso Natural Gas Co.*, 11 FPC 1071. The Commission also removed a 34 Bcf annual ceiling on volumes transported through El Paso's system. The ceiling had been imposed when the El Paso pipeline from the San Juan Basin was originally certificated.

At present, the interest owners of GLA 47 (successors to Delhi's rights) are Tenneco Oil Company and Continental Oil Company. Both of these companies have demanded increased overriding royalty payments from El Paso. Both Tenneco and Continental were parties to the U.S. District Court suit in Midland, Texas.

VI

It was as if the execution of GLA 47 had broken a logjam.

After the March 1, 1952 closing of GLA 47, El Paso's program of acquiring gas reserves in the San Juan Basin through purchases similar to the so-called "Delhi deal" proceeded rapidly. In all, the pipeline made 36 lease-sale contracts with the owners of gas leaseholds in the Basin, thereby acquiring the gas underlying more than a quarter of a million acres.[61]

Although it took some six and one-half years to consummate all of the agreements, the large tracts were acquired early in the program. Almost two-thirds of the acreage (some 65.6% of it) was under contract by January 1953, a year after execution of the first GLA, and the contracts for more than 80% (82.5%) of the acreage had been signed by July 8, 1953, some 18 months after GLA 47 came into being.

The essential details of the GLA acquisitions are provided in the following table:

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[61] Only 35 of the GLA contracts are implicated in this case. The exception is GLA 153, which is shown on Exhibit 36 as having been executed on May 10, 1953. Francis I. Harvey is identifed as the interest owner. For reasons which are not presently apparent, the Commission did not designate the GLA 153 interest owners as respondents when it initiated this case. See Tr. 412.

GLA No.	*Date Signed*	*Date Closed*	*Original Owner*	*Present Owner*	*Prior Gas Purchase Contract*[d]
47	1/18/52	3/1/52	Delhi Oil Corp.	Tenneco Oil Co. & Continental Oil Co.	No
51	2/29/52	3/1/52	J. Glenn Turner	Mapco Production Co. & Hopi Oil Co.	Yes
52	4/19/52	5/16/52	Three States Nat. Gas Co.	Tenneco/Conoco	Yes
60	9/26/52	1/22/53	San Juan Drilling Co., *et al.*	Tenneco/Conoco	No
61	9/26/52	1/5/53	Sunray Oil Co.	Sun Oil Co.	No
62	10/10/52	3/18/53	Blackwood & Nichols Co.	F.H.N., Ltd.	No
63	1/23/53	2/20/53	Atlantic Refining Co.	Atlantic Richfield Co.	No
66	3/31/53	4/24/53	Lucerne Corp.	W. Watson LaForce, *et al.*	No
72	6/2/53	7/15/53	J. Glenn Turner	Mapco/Hopi	Yes
76[a]	7/6/53	1/4/54	Johnston Oil and Gas Co.	Union Oil Co. of Cal.	No
77[a]	7/6/53	1/3/54	R. E. Beamon	Robert Beamon, *et al.*	No
78	7/8/53	7/27/53	Three States & Albuquerque Ass'd. Oil Co.	Tenneco/Conoco, Am. Petrofina, *et al.*	No
86	12/1/53	12/1/53	J. Glenn Turner	Mapco/Hopi	Yes
101	4/2/54	4/2/54	J. Glenn Turner	Mapco/Hopi	Yes
106	5/25/54	7/1/54	Morris Mizel, *et ux.*	Morris Mizel, *et ux.*	Yes
122	10/12/54	12/1/55	White, McMillan & McLane	Producing Royalties, Inc., *et al.*	Yes
125[a]	11/10/54	11/30/56	Benson-Montin, *et al.*	American Petrofina Co.	Yes
127	12/1/54	12/1/54	J. Glenn Turner	Mapco/Hopi	Yes
129	12/24/54	11/30/56	Delta Drilling Co.	Delta Drilling Co., *et al.*	Yes
139	3/3/55	2/1/58	White & McLane	Producing Royalties, Inc. *et al.*	Yes
152[a]	4/1/56	4/1/56	Webb & Turner	Turner & Webb	Yes
157[a]	6/1/55	6/1/55	Turner & Webb	Turner & Webb	Yes
160[a]	7/1/55	7/1/55	Turner & Webb	Turner & Webb	Yes
172	4/29/55[b]	9/24/53[b]	Beaver Lodge Oil Corp.	Crown Central Petroleum Corp.	Yes
195[a]	1/9/56	1/9/56	Turner & Webb	Turner & Webb	Yes
196	12/28/55	12/28/55	Turner & Webb, *et al.*	Turner & Webb, *et al.*	Yes
197	12/28/55	12/28/55	Huerfanito Drilling Co.	Huerfanito Drilling Co.	No

GLA No.	*Date Signed*	*Date Closed*	*Original Owner*	*Present Owner*	*Prior Gas Purchase Contract*[d]
198[a]	12/28/55	12/28/55	Turner, Webb & Schultz, *et al.*	Turner, Webb & Schultz, *et al.*	Yes
231[a]	12/1/55	12/1/55	Turner, Webb & Abraham	Turner, Webb, *et al.*	Yes
248[a]	1/8/57	1/8/57	Turner, Webb & Schultz	Turner, Webb & Schultz	Yes
249[a]	1/8/57	1/8/57	Turner & Webb	Benson-Montin-Greer Drilling Corp., *et al.*	Yes
348*	7/29/58	8/1/58	Texas Nat'l Petroleum Co.	Union Oil Co. of Cal.	No
349**	7/29/58	7/29/58[c]	Texas Nat'l Petroleum Co.	Union Oil Co. of Cal.	No
350*	8/5/58	8/5/58	R. E. Beamon	Robert Beamon, *et al.*	No
351**	8/5/58	9/9/58	R. E. Beamon	Robert Beamon, *et al.*	No

*GLAs 76, 77, 348, and 350 related to the same acreage.

**GLAs 349 and 351 related to the same acreage.

[a]GLAs which were the subject of the case of *William G. Webb, et al.* (Op. No. 642), 49 FPC 17 (1973).

[b]Leases were transferred on September 24, 1953 pursuant to a letter agreement dated July 30, 1953. Formal GLA contract was signed on April 29, 1955.

[c]Exhibits 42 (Rev.) and 36 show closing date as 9/9/58. CPFF No. 432 gives it as 7/29/58.

[d]"Yes" indicates that, prior to the lease-sale, El Paso purchased gas from the acreage under a wellhead sale.

As the table indicates, the number of separate tracts of land involved was somewhat less than the number of GLA contracts. Four of the agreements GLAs 76, 77, 348 and 350, related to the same acreage, with the latter two transactions transferring to El Paso the deeper horizons of the tract. Similarly, both GLA 349 and GLA 351 related to the same acreage, with the first transferring five-sixths of the working interest and the second transferring the remainder.

In the case of almost half the contracts—16 of them—we find that the interest owner who sold the leasehold consisted of J. Glenn Turner, Delhi's General Counsel, one of Turner's partners in the Dallas law firm of Turner, Atwood, White, McLane and Francis, or both.[52] Whether these corporate lawyers were acting for themselves or as agents for others is a question upon which the record offers no enlightenment. Eight of the Webb-Turner GLAs, plus GLA 125, were the subject of the Federal Power Commission's Opinion No. 642.[53]

As the table above indicates, natural gas from the acreage involved had been sold to El Paso under conventional wellhead sale contracts before the Webb-Turner GLA contracts were signed. In order to transfer the leasehold interests, it was necessary for the seller, in each case, to obtain the Commission's approval; technically, the transmutation of the conventional wellhead sale into a sale of the leasehold and its underlying reserves constituted an "abandonment" of the conventional sale, for which authorization was required under Section 7 of the Natural Gas Act.[54] There is, however, no explanation of why the 13 other GLA contracts which replaced prior wellhead sales were not also the subject of abandonment cases.

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[52] Besides Turner, two the firm's partners who turned up as sellers, were William G. Webb and Alfred E. McLane.

[53] *William G. Webb, et al.*, 49 FPC 17 (1973).

[54] 15 U.S.C. 717f.

The following table [see 66a-67a] shows the number of wells on the acreage covered by each of the GLA contracts as of the date the contract was signed and as of the date the property transfer was closed. In some cases, *e.g.*, GLAs 139 and 172, a substantial period of time elapsed between the two dates, during which a substantial number of wells were drilled. The record does not disclose why the lengthy hiatus occurred in some cases and not others. We may infer that, in those instances where the closing was delayed, the seller found it financially attractive to "drill up" his acreage and to sell the wells to El Paso at the price specified in the contract. The table also contains an estimate of the size of the parcel transferred under each of the GLA contracts. In this connection, it should be noted that, during the period of El Paso's lease-sale acquisitions, New Mexico law set a maximum on the number of wells that could be drilled on a tract of a given size. The maximum was one Pictured Cliffs well for each 160 acres and one Mesaverde well for each 320 acres.

The formats of the GLA agreements all followed essentially the same pattern. In exchange for the lessee's agreement to transfer the gas leasehold (either the lessee's interest in all the acreage or only his rights in certain horizons), El Paso agreed to pay a lump sum at the closing to purchase the wells and gas-drilling-and-production equipment located on the acreage. In some cases, there was also a specified lump-sum payment which was not tied to any particular personalty transfer—a sort of "bonus" to the owner of the leasehold.[65]

The principal compensation to the interest owner, however, took the form of periodic payments which were to be made as El Paso produced the gas and other hydrocarbons. The payment was termed an "overriding royalty." In about half the

[Text continues on p 68a, after table]

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[65] In two cases, GLA 63 with Atlantic Richfield and GLA 66 with Lucerne Corporation *et al.*, there were no wells on the acreage, and there was no provision for payment of a lump sum at closing.

GLA No.	*No. of Acres*	*Wells on Date Signed*	*Wells on Date Closed*	*Remarks*
47	102,400	15MV 9PC	16MV 9PC	Only 11 MV and 7 PC wells purchased as "commercial."
51	841.71	3MV 1PC	3MV 1PC	PC well is not shown on Exh. 41, Tab 1 map.
52	29,631.21	6MV 1PC	7MV 1PC	El Paso's Exh. 42 (Rev.) shows 8 MV wells.
60	3,500	1MV	7MV	Exh. 42 (Rev.) shows 8 MV wells. Contra: Exh. 40 EP 40.
61	11,400	3MV	4MV	2 incomplete wells on 1/5/53 closing date.
62	See remarks	2PC	2PC	1,081 acres in initial transfer. 11,520 acres eventually transferred. 1 well not deemed "commercial."
63	5,080	0	0	
66	2,480	0	0	
72	2,443.69	2MV	2MV 13PC	Exh. 42 (Rev.) shows 4 MV wells at closing. Map (Ex. 41, Tab 3) shows only 2 complete.
76	26,687.71	4PC	19PC 3MV	Same acreage as GLAs 77, 348, 350. 1 incomplete PC well at closing.
77	do.	do.	do.	Same acreage as GLAs 76, 348, and 350.
78	10,423.49	2MV	2MV	
86	320	1MV	1MV	
101	800	5PC	5PC	
106	1,480	2MV	2MV	
122	1,280	0	8PC	
125	9,250.25	5PC	49PC	Acreage has only 48 wells today.
127	1,760	6MV 5PC	6MV 5PC	
129	5,286.31	6PC	31PC	
139	3,429.17	0	19PC	Map (Exh. 40 EP 40) shows 2 PC wells on 3/3/55 execution date.

152	1,921.36	12PC	12PC	
157	3,760	24PC	24PC	
160	320	2PC	2PC	
172	1,201	11MV	11MV	GLA confirmed 7/30/53 letter agreement.
195	1,600	10PC	10PC	
196	2,885.30	18PC	18PC	
197	160	1PC	1PC	
198	960	6PC	6PC	
231	480	3FR	3FR	Fruitland (FR) wells were shallower than PC wells.
248	920.69	7PC	7PC	
249	4,720.81	1MV	1MV	
		32PC	32PC	
348	26,687.71	2DK	2DK	Same acreage as GLAs 76, 77, and 350. GLAs 348 and 350 transferred Dakota formation rights.
349	1,283.48	5PC	5PC	Exhs. 42 (rev.) and 36 show closing date as 9/9/58. CPFF (p. 110) says 7/29/58.
350	26,687.71	2DK	2DK	Same acreage as GLAs 76, 77, and 348. GLAs 348 and 350 transferred Dakota formation rights.
351	1,283.48	5PC	5PC	Same acreage as GLA 349.

Total acreage = 250,226.78

cases (17), the royalty was payable as long as gas was produced from the acreage. In the remainder, the royalty went to liquidate El Paso's obligation to make a lump-sum "production payment." Since the amount of the "production payment" was usually calculated on the basis of the maximum volume of reserves thought to underlie the acreage, it made very little practical difference which form the obligation took.

Under the typical arrangement, El Paso's initial payment was pegged at between five and six cents per Mcf. During most of the period, the wellhead price of gas in the Basin hovered between ten and twelve cents per Mcf, and the cost of production was thought to vary between five and seven cents per Mcf. Hence, the initial price, in many cases, closely approximated a fair estimate of the profit after production expenses that could have been anticipated from a wellhead sale. The initial payment escalated, usually by one cent per Mcf, at specified intervals until the agreement was either ten years old (in the case of the Turner, Webb-Turner, and GLA 47 agreements) or 15 years old (in the case of all the other agreements). Thereafter, the price was to be the wellhead value of the gas, fixed by mutual agreement or, failing that, by arbitration at five-year intervals, but not less than the last specified escalation.

For example, the compensation provisions of one contract (GLA 52) provide, in Article III, Section 2, that the interest owner, Three States Natural Gas Company, "reserves and retains to itself and its successors and assigns, or to person(s) whom Three States may designate, the following:

Paragraph A. An overriding royalty on Three States' interest in all gas produced and saved from the said leases and the subject lands being sold herein as follows:

(1) 5¢ per Mcf on all such gas produced and saved during the first 3 1/3 years after the date of closing.

(2) 6¢ per Mcf on all such gas produced and saved during the next 3 1/3 years thereafter.

(3) 7¢ per Mcf on all such gas produced and saved during the next 3 1/3 years thereafter.

(4) 8¢ per Mcf on all such gas produced and saved during the next one year thereafter.

(5) 9¢ per Mcf on all such gas produced and saved during the next three years thereafter.

(6) 10¢ per Mcf on all such gas produced and saved during the next one year thereafter.

(7) Not less than 10¢ per Mcf on all such gas produced and saved thereafter.[66]

The GLA 52 contract went on to provide that, when 15 years have elapsed from the date of the closing, the parties would attempt to agree on the amount of the overriding royalty for the ensuing five-year period, and that the agreed figure would be at least the ten-cents-per-Mcf final price specified in the above-quoted schedule. In the absence of mutual agreement, the contract said,

> such amount shall be determined by a board of arbitrators * * *. The board of arbitrators, in determining the amount of an overriding royalty, shall base their decision on the then value of such gas at the well head, considering only quality and pressure of gas, aggregate quantity of delivery and the then current field prices (of then newly negotiated contracts) of gas in other fields connected to or in the area of any of El Paso's pipe lines or gathering systems * * *.

This process of setting the royalty at the wellhead value of the gas produced from the lease was to be undertaken anew after the twentieth year from the date of closing and at intervals of five years thereafter. In any event, however, the ten-cents-per-Mcf figure was to remain a floor under the amount of the royalty payment.[67]

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[66] Exh. 25, p. 7. The interest of Three States Natural Gas Company is now held by Tenneco Oil Company and Continental Oil Company.

[67] Exh. 25, pp. 7-9. In GLAs 348, 349, 350, and 351, the initial price-redetermination date was fixed at January 1, 1969 and was not measured from the date of contract closing. These exceptions to the general pattern may be related to the fact that those four contracts

In all but one of the agreements (GLA 153), the interest owner reserved an overriding royalty interest in any liquid hydrocarbons (except oil) that El Paso might produce from the horizons transferred to the pipeline. Typically, the overriding royalty was one-third of the seller's interest in the liquids, payable either in cash or in kind at the interest owner's option. The interest owner also specifically reserved all rights to any oil that might underlie the acreage and to all gas or other hydrocarbons in formations not conveyed.

Each of the agreements obligated El Paso to develop the acreage in a manner which would avoid forfeiture of the underlying lease. Also, the agreements expressly or by implication imposed on the pipeline certain minimum requirements to drill new wells and to take gas from existing wells. For example, in GLA 77 and GLA 76, both of which covered the same acreage, El Paso was bound to drill, within seven and one-half years from the date of closing, at least one Mesaverde well on each 320-acre Mesaverde drilling unit and one Pictured Cliffs well on each of the 160-acre Pictured Cliffs drilling units authorized by the New Mexico Oil and Gas Commission. In agreements where there was no specific obligation to drill and produce from new wells to be made at El Paso's expense, the pipeline's obligation to develop was a function of the take-or-pay clause. As is indicated above, that clause required El Paso to take or pay for an annual average of 25% of the aggregate open flow capacity of all the wells on the acreage on the basis of an 80% load factor. This type of clause was generally found in agreements pertaining to acreage that had, at the time of closing, about the maximum amount of wells allowed by State law—so that it was thought unnecessary or futile to provide for additional drilling.

GLA 198, for example, involved the transfer of rights to the gas in the Pictured Cliffs formation underlying one and one-

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involved acreage that had been transferred in prior GLAs. In any event, the interval between redetermination dates provided for in GLAs 348, 349, 350, and 351 was the standard period of five years.

half sections. At the time of closing, there were six Pictured Cliffs wells on the acreage, or one well per 160 acres.[28] Article VII, Section 1 of the contract (entitled MINIMUM GAS PRODUCTION AND DEEP GAS PRODUCTION) provided as follows:

> El Paso agrees that it will promptly commence and continue taking gas from wells now existing or which may hereafter be completed in the zones and/or formations in the leases and operating agreements being sold to it hereunder, subject to the physical capacity of the wells to produce the quantities hereinafter provided for against the line pressures of El Paso's gathering system, and likewise subject to requisite authorization to produce such volumes under the rules and regulations of governmental authorities having jurisdiction thereof, provided, however, that El Paso shall take gas hereunder at natural well head flowing pressures and shall have the right to operate its gathering system at pressures up to, but not exceeding 250 PSIG. * * *
>
> Subject to the foregoing provisions hereof, El Paso shall take from Pictured Cliffs wells now existing or which may be hereafter completed on the subject lands and leases, an amount of gas each day equal to twenty-five percent (25%) of the aggregate open flow capacity of all such wells on the basis of an eighty percent (80%) load factor, averaged annually. In lieu of taking the minimum quantities of gas required by this Agreement, El Paso may pay to each Assignor, in cash, all amounts which would have been due to such Assignor hereunder had such quantities been taken. * * * Any gas paid for by El Paso but not taken during any year by virtue of the minimum take or pay provisions hereof may be taken by El Paso from the subject lands at any time thereafter out of any production in excess of the minimum quantities above provided for during the period or periods in which such quantities are being made up.[29]

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[28] See Exh. 41, Tab 16.

[29] Exh. 16, pp. 19-21.

A number of the GLAs contained a so-called reconveyance clause, a provision which operated to limit El Paso's risks.[70] The clause gave El Paso the right to reassign to the interest owner acreage or wells that proved to be unprofitable or non-commercial, thereby liquidating its obligation to make good on the lessee's duties to the landowner with respect to the acreage or the wells.

A relatively straightforward example of a reconveyance clause, one dealing only with the possibility of an unprofitable well, appears in GLA 106, which El Paso entered into with Mr. and Mrs. Morris Mizel on May 15, 1954. A paragraph found in Article VI, Section 3 of the agreement reads as follows:

> In the event the operation of any well now or hereafter drilled by El Paso shall become unprofitable, then El Paso shall have the option upon sixty (60) days' notice to Mizel to reassign to Mizel such well and the unit upon which such well is situated, and in such event Mizel shall have the option to sell gas produced therefrom to El Paso at the highest price paid for gas of like kind and quality in the field by El Paso or any other bona fide pipeline company, and El Paso agrees to purchase such gas at such price.[71]

GLA 106, it should be noted, involved a relatively small parcel. A more complex reconveyance clause appears in agreements for more substantial blocks of acreage, such as GLA 78 with both Three States Natural Gas Company and Albuquerque Associated Oil Company. In that agreement, which conveyed drilling rights to both Pictured Cliffs and Mesaverde horizons underlying more than 15 square miles, the clause[72]

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[70] The clause tended to appear in the earlier contracts. It is found in the seminal GLA 47, in GLAs 52, 60, and 61, respectively in the second, third, and fourth of the GLAs signed, and in GLAs 76, 77, 78, and 106.

[71] Exh. 30, p. 8.

[72] Part of Article VI, Section 2 of Exh. 29 at pp. 14-15.

read as follows (the interest owners are designated as FIRST PARTIES with El Paso as SECOND PARTY):

> In the event that development hereafter in the area of or adjacent to any drilling units should evidence that such drilling unit will not be productive of gas in commercial quantities in the formation applicable to such drilling unit as above specified and for such reason SECOND PARTY shall not desire to drill such well thereon, then SECOND PARTY shall promptly reassign any such drilling unit to FIRST PARTIES or to any person whom FIRST PARTIES may designate and thereupon shall be relieved of its obligation to drill a test well thereon to the formation applicable; provided that SECOND PARTY may retain any commercial gas well completed therein in a shallower or deeper formation, together with its rights in such drilling unit down through such shallower or deeper formation. In the event the operation of any well now or hereafter drilled shall become unprofitable, then SECOND PARTY shall have the option upon sixty (60) days' notice to FIRST PARTIES to reassign to FIRST PARTIES such well and the unit upon which such well is situated, and in such event FIRST PARTIES shall have the option to sell gas produced therefrom to SECOND PARTY at the highest price paid for gas of like kind and quality in the field by SECOND PARTY or any other bona fide pipeline company, and SECOND PARTY agrees to purchase such gas at such price.

All of the GLA agreements featured a favored nations clause. The standard clause, which is virtually identical in all of the contracts, obligated El Paso to pay the interest owner any higher price it might subsequently pay under a lease-sale agreement involving lands within a 200-mile radius of the acreage. Since the Basin, at its widest point, was considerably less than 200 miles across, the provision for payment of the highest price that El Paso negotiated for lease-sales within a radius of 200 miles assured each interest owner that he would be treated on a par with all other sellers of leases in the San Juan Basin. In this context, it should be noted that at that time El Paso was the only pipeline making lease-sale contracts and the only one that seemed likely ever to do so.

VII

El Paso was not to be alone for long, however.

As the United States entered the 1950's, the Pacific Northwest area of the country remained as the last major untapped market of the natural gas industry. On June 28, 1950, PNW asked the Federal Power Commission for authority to serve that region and local distributors in its major metropolitan areas, Seattle, Washington and Portland, Oregon with natural gas. The application contemplated the construction and operation of a long-distance pipeline commencing in Wharton County, Texas and rooted in the gas fields of the Texas Gulf Coast.

By the Spring of 1952, however, PNW's focus had shifted from the Texas Gulf Coast as its gas-supply source to the San Juan Basin, an area more than a thousand miles closer to the potential market. On August 27, 1952, PNW amended its application for a certificate of public convenience and necessity to specify that the proposed pipeline would be anchored in the San Juan Basin.[73]

A major task for PNW was to secure dedication of reserves to its proposed system. To do so, PNW sought commitments from independent producers who owned substantial reserves in the San Juan Basin. PNW offered a number of the producers the option of either a conventional wellhead sale of natural gas or, alternatively, a sale of the gas reserves in place, with the producers reserving an overriding royalty that would vary with the quantity of gas produced. Under the "wellhead sale" option, PNW originally offered to pay ten cents per Mcf for the first five years, with an escalation of one cent per Mcf every five years thereafter. Under the "in-place" option, PNW offered an initial price of five and one-half cents per Mcf and

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[73] The full scope of the proposal was massive, calling for the construction of an entirely new pipeline system consisting of 1,184 miles of main line and approximately 150 miles of lateral lines. The plans contemplated that, by the third year of operation, the PNW pipeline would carry its maximum design capacity: 314,000 Mcf of gas per day.

periodic escalations thereafter, with the producer having the option to price the gas at its fair market after the twelfth year. Subsequently, PNW raised its offering price under both options; it offered 12 cents per Mcf as the initial price for a wellhead sale and approximately seven cents per Mcf as the initial price for a gas-in-place sale. The complainants say that the five-cent-per-Mcf difference between the two options reflected the costs that would be incurred by one who performed the functions that fell to the operator of a gas lease, *e.g.*, drilling, operation, and payment of production taxes.[74] There is some indication that contemporaneous computations by persons knowledgeable in the business of extracting gas from San Juan Basin reservoirs calculated those costs at about 4.5 cents per Mcf. However, nothing in the record tells us convincingly whether the close approximation of those two figures was the result of design or happenstance.

PNW's first success on the road towards obtaining the reserve commitments it needed was achieved on June 12, 1952. On that date, PNW entered into a "commitment" agreement with Phillips Petroleum Company. Under the agreement, Phillips conditionally dedicated acreage in the Basin to PNW. Phillips retained the option of selecting either a conventional wellhead sale or a sale of gas in place as the ultimate form of the transaction. Phillips exercised its option on January 9, 1953, when it formally executed a lease-sale agreement with PNW, thereby choosing the in-place-sale option. The lease-sale agreement, which was eventually denominated PLA 5, covered approximately 202,000 acres located generally in the northern and eastern portion of the Basin. Under the agreement, PNW acquired rights in the Phillips leases down to, and including, the Mesaverde formation.

The lease-sale agreement contemplated the transfer to PNW of 3 Tcf of recoverable gas reserves. PNW was obligated, after a period of time, to reassign to Phillips acreage

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[74] See CPFF Nos. 476-77, p. 118.

underlaid by any reserves in excess of the 3 Tcf figure. Phillips reserved an "overriding royalty" on all gas produced by PNW from the PLA 5 acreage. During the first year after gas from the PNW pipeline was first sold for resale, the royalty payment was to be seven cents per Mcf. After that first year, the price was to be eight cents per Mcf for the next nine years. During the succeeding year, the eleventh after the pipeline first began operation, the price was to be nine cents per Mcf. Then, the price was to rise to ten cents per Mcf, where it would remain until 20 years had elapsed from the opening of the PNW line. After expiration of those first 20 years, the price was to be redetermined under a formula: the redetermined price would be 75% of the average of the three highest wellhead prices being paid by any pipeline in the Basin for high-volume (20,000 Mcf/d or more) deliveries. In no event, however, could the redetermined price be less than eleven cents per Mcf for the first five years, plus one cent per Mcf for each five years thereafter.

Under the agreement, Phillips reserved all rights to oil and casinghead gas in the formations transferred to PNW and all rights to any hydrocarbons found below those formations.[75] PNW agreed to reimburse Phillips at the closing for Phillips' costs of drilling and completing every well on the acreage as of the closing, if the well met minimum standards of production.[76] PNW was obligated to develop the acreage in such a manner that there would be at least 250 net wells completed on the acreage by July 1, 1955.[77] PNW was given the right to reassign

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[75] That is, below the base of the Mesaverde.

[76] The standards specified that a well would have to produce at least 750 Mcf/d against atmospheric pressure after a three-hour flow to be eligible. At the time the agreement was made, the estimated cost of drilling such a well into the Mesaverde formation was $90,000.

[77] When acreage is communitized, the production of a well drilled on that acreage is shared by all working interest owners in proportion to their contributions to the communitized acreage. See Tr. 305-06. Hence, if Phillips' rights applied to one-half of a proration unit, a well

to Phillips any acreage which it decided would be unprofitable or uneconomical to develop, thereby relieving itself of all obligations to develop that acreage.

The contract required PNW to acquire from the San Juan Basin (either by purchase, production, or both) all of its daily gas requirements up to 350 MMcf per day, except for 20 MMcf per day, which could be secured from other places. PNW could fulfill this requirement with gas from the Phillips acreage or from elsewhere in the Basin. The 350-MMcf/d figure gave PNW very little leeway to look to sources other than those in the Basin, in light of the fact that the initial design capacity of its pipeline was to be 314 MMcf/d.[78]

Since the contract was executed at a time when the pipeline did not exist as such, it is not surprising to find that the parties made the contract's viability contingent upon two events: First, PNW would have to obtain the requisite certificate of public convenience and necessity from the Federal Power Commission. Second, PNW would have to obtain a satisfactory certificate of financing from a reputable financial institution.

At about this time, other independent producers in the San Juan Basin were recipients of similar offers from PNW. On July 21, 1952, PNW made its option proposal to the Stanolind Oil and Gas Company, which owned substantial reserves of natural gas in the Basin. At first, Stanolind refused to commit any acreage to PNW under either branch of the option scheme. Subsequently, however, Stanolind entered into three "commitment" agreements, dated March 13, 1953, March 10, 1954, and February 1, 1955, with PNW. Under these agreements, Stanolind conditionally assigned over 146,000 acres to PNW.[79]

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drilled on the unit would constitute one gross well but only one-half of a net well. Two such wells would add up to one net well. Consequently, meeting an obligation to have 250 net wells on the PLA 5 acreage by July 1, 1955 might well entail drilling many more wells than that.

[78] See n. 73, *supra*.

[79] The March 13, 1953 agreement, together with an agreement dated eleven days earlier, conditionally assigned acreage in which

These "commitment" agreements, like the original Phillips "commitment" agreement, were not lease-sale agreements. Their purpose was simply to secure sufficient promise of an adequate supply of natural gas to demonstrate the viability of PNW's pipeline project to both the FPC (in the pending certificate proceeding) and the financial community (which would be asked to some up with the capital to construct the project). Lease-sale agreements were, in fact, executed with Stanolind in March of 1955.

On July 13, 1953, Sinclair Oil and Gas Corporation and PNW entered into PLA 2, a lease-sale agreement covering some 3,600 acres located in the northwest corner of the San Juan Basin. The agreement contained essentially the same provisions as were found in the Phillips agreement (PLA 5), with only minor variation.[80] The contract did not contain either a take-or-pay clause or a favored nations clause.

The next "commitment" agreement was between PNW and Skelly Oil Company. It was entered into on July 29, 1953 and covered approximately 19,000 acres scattered throughout the San Juan Basin.[81] The text of the "commitment" agreement noted that PNW had entered into a lease-sale with Phillips and simply incorporated the terms of the Phillips lease-sale con-

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both Stanolind and Colorado Oil and Gas Company held interests. CPFF No. 490, p. 122.

[80] For example, PLA 2 required PNW to drill at least ten net wells on the acreage by July 1, 1955, whereas PLA 5 called for PNW to have 250 net wells by that date on the acreage transferred by Phillips. See Exh. 47, "Contract," p. 8. Unlike the Phillips contract, PLA 2 did not recite the parties' intention to assign a specific volume of gas to PNW. The overriding royalty and redetermination provisions of the two contracts were, however, markedly similar. As was the case in the earlier PLA, the contract with Sinclair was conditioned upon PNW obtaining an FPC certificate to build and operate the pipeline.

[81] The Skelly acreage was the subject of PLA 3 and is colored purple on the map that is Exh. 95.

tract (PLA 5) by reference. In addition to the terms that Phillips secured, Skelly demanded, and eventually received, a favored nations clause, and a ratable-take clause to assure that its acreage would be developed at the same rate as other San Juan Basin acreage under contract to PNW. As was the case with the earlier agreements, the Skelly "commitment" was conditioned upon issuance of an FPC certificate to PNW.[82]

On August 5, 1953, the Chicago Corporation (Chicago) and PNW signed a lease-sale agreement. The agreement, PLA 14, covered approximately 3,800 acres located generally in the eastern portion of the Basin.[83] PLA 14 was similar in nature to PLA 2, the Sinclair lease-sale agreement, that had been executed less than a month previously. PLA 14 did not have either a take-or-pay clause or a favored nations clause. In this respect, too, it was like the Sinclair contract. Its pricing provisions were similar to those that would ultimately be incorporated into the Phillips agreements: a two-tiered pricing system, in which Mesaverde gas was priced in accordance with the well's deliverability rate, while gas from other formations was priced in the more conventional manner.[84] In all other major respects, however, PLA 14 was substantially identical to the Sinclair (PLA 2) and Skelly (PLA 3) agreements.

The commitment of gas reserves to PNW under the agreements discussed above was apparently sufficient to carry the day for PNW in the Federal Power Commission's proceedings. The Commission had consolidated PNW's application with other competing applications for authority to serve the Pacific

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[82] See Exh. 48.

[83] PNW had sent Chicago an option proposal by letter dated January 9, 1953. Chicago accepted the proposal, thereby entering into a "commitment" agreement, four days later. See Exh. 72; Tr. 261-62.

[84] The Phillips agreement was, in fact, amended to include a variable-price structure for Mesaverde gas. The amendment took place on August 4, 1953, only four days after the execution of PLA 14 with Chicago.

Northwest and had conducted a comparative hearing. One of the issues, which the Commission resolved favorably to PNW, was whether there were sufficient reserves of natural gas dedicated to the proposed service.[55] In Opinion No. 271, issued on June 18, 1954, the Federal Power Commission granted to PNW the certificate of public convenience and necessity that it had sought.[56]

Only two more "commitment" agreements were signed after the Commission's action. The last of them, the February 1, 1955 agreement between PNW and Stanolind, has been discussed above. The other was an agreement, executed January 25, 1955, between T. H. McElvain and PNW, which committed gas reserves down to the base of the Mesaverde formation underlying some 1,500 scattered acres in the San Juan Basin.[57] From our standpoint, the most significant feature of the McElvain commitment agreement (which eventually matured into PLA 4) is that it specifically incorporated by reference the provisions of the Phillips lease-sale agreement—PLA 5—with only minor variations.

On February 11, 1955, the Federal Power Commission approved PNW's plan of financing for its proposed pipeline. This step rendered PNW's certificate final and permitted PNW to close many of the conditional commitment and lease-sale agreements into which it had previously entered:

—On February 22, 1955, PLA 14 between PNW and Chicago was closed. Leasehold interests in approximately 3,800 acres were conveyed to PNW. There were no wells on the acreage at the time of the closing. The present interest owner under PLA 14 is Champlin Petroleum Company.

—PLA 5, between Phillips and PNW, was closed one day later, on February 23, 1955. Approximately 188,700 acres were assigned. There were 75 wells, for which PNW paid

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[55] *Northwest Natural Gas Co.*, 13 FPC 221 (1954).

[56] *Id.* at 238-39.

[57] See Exh. 95, on which the McElvain acreage is colored yellow.

approximately $5,600,000, on the acreage at the time of the closing.[88] Phillips remains the interest owner under PLA 5 today.

—Skelly and PNW closed on PLA 3 on March 3, 1955. At the time of closing, there were seven wells on the acreage, and PNW paid a total of $452,270 for those wells. The present interest owner under PLA 3 is Getty Oil Company.

—On March 8, 1955, Sinclair and PNW closed on PLA 2, which transferred Sinclair's rights to about 3,600 acres. PNW paid $46,615 for the one well that was on the acreage at the time of the closing. Atlantic Richfield is the present owner.

—Eight separate lease-sale agreements between Stanolind and PNW were both executed and closed on March 16, 1955. The agreements covered a total of approximately 146,000 acres in the San Juan Basin. The eight separate tracts were widely scattered around the rim of the Basin. Six of the lease-sale agreements, covering approximately 116,150 acres, are PLAs 6-11, which are involved in this proceeding. The other two were aborted when PNW reassigned the acreage covered by the agreements to Stanolind in accordance with its contractual right to give back any acreage judged unprofitable or uneconomical to develop.[89] The texts of PLAs 6-11 were all essentially similar, although there were some minor variations. At the time of the closing, there were 40 wells on the acreage. PNW paid approximately $1,400,000 for the wells. The present interest owner under PLAs 6-11 is Amoco Production Company.

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[88] The record does not contain a breakdown of the wells on this, or any other, PLA acreage as between Mesaverde wells, Pictured Cliffs wells, or wells in any other formation.

[89] The PLA contracts covered acreage in the Bondad area (PLA 6), the Huerfano area (PLA 7), the Ignacio area (PLA 8), the Northwest Cedar Hill area (PLA 9), the Rosa unit (PLA 10), and the Township units (PLA 11). The areas covered by the two agreements which were reassigned were the Arboles and the North Rosa areas. They are not at issue in this case.

—PLA 4, between PNW and T. H. McElvain, was closed on September 1, 1955. On that date, there was one well on the 1,500 acres transferred to PNW. McElvain, *et al.* are the interest owners under PLA 4 today.

The last of the PLA agreements was PLA 13, executed and closed on April 23, 1957, some 20 months after the rest of the PLA agreements. Under PLA 13, General Petroleum Corporation transferred to PNW leasehold interests in some 13,000 acres located in La Plata County, Colorado, in the northern portion of the San Juan Basin. The agreement was similar in nature to the Stanolind agreements (PLAs 6-11) with only minor variations.[90] On April 23, 1957, the date of closing, there were two wells on the acreage subsumed by PLA 13. As of that date, gas from the PLA 13 acreage had been flowing in interstate commerce via the PNW pipeline for seven months.

The last step needed to permit PNW to build the pipeline had been taken in New York City a little less than two years before PLA 13 was closed. On May 4, 1955, the financing agreements were closed. Under those agreements, PNW issued $93,200,000 in First Mortgage Pipeline Bonds; in addition, it sold bank notes, interim notes, and common stock. With the money in hand, PNW was able to construct the pipeline rapidly. It was finished the following year, and on September 1, 1956, natural gas began to flow through it from the San Juan Basin to consumers in Seattle and Portland.

El Paso's purchase of PNW, which took place in 1957, and the merger of the two companies in 1959 touched off more than a decade of antitrust litigation.[91] As a result of the lawsuits, El

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[90] For example, PLA 13 imposed on PNW development obligations which were somewhat less stringent than those in the Stanolind agreements. Another provision of PLA 13 gave General Petroleum the right to require PNW either to drill in any location General Petroleum might specify or reassign it to General Petroleum. The Stanolind agreements contained no comparable provision.

[91] Citations to the litany of cases arising out of the Government's suit to compel El Paso to divest itself of the former PNW assets are set forth at n. 10, *supra*.

Paso was compelled to divest itself of the assets once held by PNW which, after the merger, had become the Northwest Division of El Paso. The Northwest Division was acquired by Northwest Pipeline Corporation on February 1, 1974. Included among the assets purchased by Northwest in the transaction were all of the PLA agreements.

In most important respects, the terms of the PLA lease-sale agreements were similar:

Pricing. There was a basic scheme of compensating the interest owner, which recurred with few exceptions. All of the contracts called for PNW to pay the interest owner an overriding royalty, calculated as a specified sum for each Mcf of gas produced from the acreage, beginning on a specified date.[92] The initial price was 7 cents per Mcf, except for Mesaverde gas produced under PLAs 4, 5, and 14. The first increment of Mesaverde gas under those three contracts was priced at 6 cents per Mcf, but that base rate could be higher, depending on the rate at which the well produced. The contracts all provided for periodic escalations of the base rate at specified intervals for the first 20 years (in the case of PLAs 2, 3, 4, 5, and 14) or for the first 25 years (in the case of PLAs 6-11 and 13). These escalator clauses called for increasing the payment by one cent per Mcf through the end of the tenth year, another cent per Mcf for the eleventh year, another cent per Mcf during years 12 through 20, and, in the case of PLAs 6-11 and 13, one more cent per Mcf in the twenty-first through the twenty-fifth years. After the twentieth year (or the twenty-fifth year under PLAs 6-11 and 13), the interest owner had the option of receiving either a continuation of the periodic one-cent-per-Mcf escalations—with the interval between escalation dates being set at five years—or being compensated under an "arithmetic average" formula. It is not necessary to go into all the complex-

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[92] In all of the contracts except PLAs 2 and 13, the date fixed for the payments to begin was the date of the first sale of gas for resale from PNW's pipeline. As it turned out, that date was September 1, 1956.

ities of the formula; its purpose was to entitle the interest owner to receive an amount equal to 75% of the average price being paid for gas sold at the wellhead in the area, if, by doing so, he would be paid more than the amount he would otherwise receive during any of the quinquennial, one-cent-per-Mcf, escalation periods. As an added feature, the interest owners under PLAs 6-11 and 13 were entitled to a *third* payment option: Commencing after the close of the tenth year, they could elect to receive an amount equal to five cents less than the average of the prices being paid for wellhead sales at the time the option was exercised.[93] Only one of the contracts, PLA 3, contained a favored nations clause. Given the multiplicity of payment options, each tending to ensure parity of treatment for the interest owner, it is not surprising that this ubiquitous provision was omitted for the most part.

Horizons and Hydrocarbons Conveyed. With the exception of PLAs 6, 7, and 8, all of the PLA agreements conveyed the gas rights in all formations from the surface down to the base of the Mesaverde. PLA 6 gave PNW rights to gas from the surface down to the base of the Morrison formation, which is below the Mesaverde. PLA 7 conveyed only rights to gas found from the surface to the base of the Pictured Cliffs formation. PLA 8 transferred gas rights in the Mesaverde and Morrison formations only; it did not give PNW any rights to Pictured Cliffs gas. In every case, the interest owners reserved all rights to oil, regardless of where it might be found.

Development and Minimum-Take Provisions. The PLA contracts contained a variety of provisions designed to assure that the acreage transferred would be fully and promptly developed. There were, first of all, conventional take-or-pay clauses, requiring PNW to take from the acreage, or pay for, a

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[93] PLA 13 provided that the wellhead prices used to compute entitlement under the formula had to be prices paid within a specified radius of the delivery point of the PLA-13 gas. PLAs 6-11 contained no such limitation.

specified minimum volume of gas. Of course, the only way PNW could acquire that minimum volume of gas was to produce it from the acreage transferred. Such a clause is found in PLA 13 and PLAs 6-11. PLA 3 had a so-called "ratable take" clause, which obligated PNW to take its natural gas supply from the PLA 3 acreage ratably with gas taken from other acreage under contract to the pipeline company. PLAs 4 and 5 contained a clause which required PNW to acquire almost all of its natural gas requirements up to 350 MMcf per day from the San Juan Basin.[94] In addition, most of the agreements imposed very specific developmental obligations upon PNW. In time, wells were to be drilled upon all available drilling locations;[95] otherwise, the acreage was to be reassigned. PLA 2, which had no take-or-pay clause or similar provision, required PNW to drill at least ten wells after the closing and to reimburse Sinclair, the interest owner, for wells which Sinclair had drilled before the closing.[96] PLA 5, which assigned the largest tract, required PNW to have at least 250 net wells on that acreage by a specified date. It also provided that the interest owner, Phillips, would be reimbursed for wells that it had drilled before the closing.[97] The Stanolind agreements (PLAs 6-11) provided for ratable development of the acreage with a minimum of 25% of it fully developed within two years, 75% of it developed within four years, and all of the acreage completely developed within seven years. PNW was also required to

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[94] See p. 48, *supra* for additional description of the contents of this clause.

[95] As we have noted above, *supra at mimeo* p. 35, the drilling of the wells was subject to spacing restrictions imposed by state law. There could be no more than one Mesaverde well on each 320-acre drilling location and no more than one Pictured Cliffs well on each 160-acre location.

[96] As it turned out, there was only one well on the PLA 2 acreage at the time of closing. See Exh. 96.

[97] There were 75 gross wells (54.3 net wells) on the PLA 5 acreage when the closing took place. They cost PNW about $5 million.

reimburse Stanolind for wells that Stanolind had drilled on the acreage before closing.[98] The development obligations of PNW under PLA 13 were somewhat less detailed. PNW was required to drill on each of two of the five different lease blocks during the first year after the closing. By December 31, 1958, there were to be at least seven wells (including those drilled before closing) on the acreage, at least one of which had to be located on each of the five Indian leases assigned under the agreement. After the third year, "orderly development" of the acreage was mandatory. However, General Petroleum was given the right to require PNW to drill at any specified well location or to reassign it.

Reassignment. All of the agreements permitted PNW to reassign to the interest owner any acreage PNW considered noncommercial In some of the agreements, PNW's discretion to exercise its reassignment rights was limited by the requirement that it must act in good faith. As we have noted,[99] PNW exercised its reassignment rights in connection with two of the parcels, both of which were reassigned to Stanolind in 1958.

VIII

As we have seen,[100] the initial lease-sale agreements were made at a time when the apotheosis of the governing law consisted of the holding in *Panhandle*[101] that the "production or gathering" exemption of § 1(b) of the Natural Gas Act[102] prohibited the FPC from assuming jurisdiction to regulate the transfer of gas leases. Looming on the horizon at that time was the *Phillips* case, in which the Commission was tentatively and

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[98] There were 40 such wells (18.021 net wells) that cost PNW $1.4 million.

[99] *Supra* at mimeo p. 53.

[100] *Supra*, n. 38.

[101] *F.P.C.* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949).

[102] 15 U.S.C. 717(b).

reluctantly dipping its toe into the dispute about the jurisdictional status of wellhead sales by independent producers.[103]

The finale of the *Phillips* case was written in 1954, just as the use of lease-sale agreements in the San Juan Basin was becoming institutionalized. In *Phillips Petroleum Co. v. Wisconsin*,[104] the Supreme Court held that a wellhead sale of natural gas by an independent producer to an interstate pipeline was a sale of natural gas for resale subject to regulation by the Federal Power Commission. Such a sale did not fall within the "production or gathering" exemption, the Court held; that exemption was applicable only to the "physical activities, facilities, and properties used in the production and gathering of natural gas."[105]

The *Phillips* decision lent added impetus to the use of lease-sale agreements as a means of transferring natural gas from independent producers to pipelines. The industry and its lawyers apparently reasoned that although *Phillips* would render a transfer via a conventional wellhead sale jurisdictional, the same transfer could be achieved without invoking the Commission's jurisdiction by structuring the transaction as a lease-sale of "gas in place" to the interstate pipeline, with the independent producer retaining an "overriding royalty," with or without a "production payment." This was thought to be the result required by the *Panhandle* holding, the integrity of which was considered unmarred by *Phillips*.

In retrospect, it is clear that such unalloyed faith in *Panhandle* was misplaced—for *Phillips* had severely undercut the notion, one of the chief premises of the *Panhandle* holding, that anything done before the gas was injected into the interstate pipeline fell outside FPC jurisdiction under the "production or gathering" exemption. In *Phillips*, as we have seen,

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[103] See *Phillips Petroleum Co.*, 7 FPC 983 (1948).

[104] 347 U.S. 672 (1954).

[105] *Id.* at 678.

the scope of the exemption was limited to the "physical activities, facilities, and properties used in the production and gathering of natural gas."[106]

No such doubts assailed the industry in the 1950's, however. During that decade, a large number of gas sale transactions, both in the San Juan Basin and elsewhere, were cast or recast in the format of lease-sale contracts or other arrangements for the sale of gas in place.

It was a comfortable world. A clear, simple, unvarying rule of law that permitted any knowledgeable lawyer with a modicum of ingenuity to place his client under, or remove him from, FPC jurisdiction as the client might wish. It lasted for about ten years. Then the *Rayne Field* case was decided.

In the *Rayne Field* case, the Supreme Court abandoned the *Panhandle* Court's fundamental hypothesis that "leases are an essential part of production"[107] and rejected the conclusion that transfers of leases *per se* were exempt from the FPC's regulatory jurisdiction.[108] Justice Harlan, delivering the opinion of the Court, said that although a transaction is cast in the form of a sale of a leasehold interest, it may still be jurisdictional if it amounts to the "economic equivalent" of a sale of natural gas subject to regulation under the Natural Gas Act.[109]

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[106] *Id.*

[107] 337 U.S. at 505.

[108] *United Gas Improvement Co. v. Continental Oil Co., supra,* 381 U.S. at 404. The Court did acknowledge that "some" lease transfers may be exempt transactions, referring to the facts of *Panhandle*, wherein leases covering *an undeveloped field* were transferred *by an interstate pipeline to a producer*, not *vice versa*. The Court thus limited the *Panhandle* holding stringently to its facts, rather than overruling *Panhandle* outright. To those who saw in the lease-sale format a perpetual exemption from unwanted Federal regulatory jurisdiction, however, *Rayne Field* was a severe blow.

[109] 381 U.S. at 400. The Court also held that the manner in which state law characterizes the transaction is irrelevant to the question of

Under the *Rayne Field* case's "economic equivalent" doctrine, a lease-sale agreement would clearly be subject to regulation as a jurisdictional sale of gas at the wellhead if it is held to be economically equivalent in substance to the conventional wellhead sale which the Court held to be jurisdictional in *Phillips*. The *Rayne Field* Court did not, however, define "economic equivalency" with precision. Nevertheless, certain controlling principles do emerge from the Court's discussion, and other elements of the doctrine may be discerned from the factual setting which was before the Supreme Court.

In *Rayne*, an interstate pipeline had made an arrangement to purchase natural gas from a consortium of producers at a specified unit price. The gas was to be produced from leaseholds in Rayne Field, Louisiana. Both the pipeline and the producers applied for the FPC certificates needed to carry out the deal—the producers sought authority to make the sale, and the pipeline applied for authority to build the facilities to connect its system to the field. Before the Commission acted, however, the parties cancelled the sales contract and "then agreed on a different method for achieving their objectives."[110] The parties agreed to cancel the wellhead sales contract and to substitute for it a lease-sale contract, under which the pipeline would purchase the producers' leasehold interests in the field. The pipeline agreed to make a lump-sum payment for the

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its jurisdicational status under the Act: "A regulatory statute such as the Natural Gas Act would be hamstrung if it were tied down to technical concepts of local law." *Id.*

[110] 381 U.S. at 396. The problem, so far as the producers were concerned, was the decision in the *Catco* case, *Public Service Comm'n* v. *F.P.C.*, 257 F.2d 717 (3rd Cir. 1958), *aff'd sub nom. Atlantic Ref. Co.* v. *Public Service Comm'n*, 360 U.S. 378 (1959), which upheld the Commission's right to condition certification of new wellhead sales upon the parties' acceptance of a lower price than the one for which they had contracted. The price in the *Rayne Field* contract was 1.5 cents per Mcf higher than the price in the *Catco* contract.

leasehold interests, but the payment took the form of notes which were payable over a 16-year period. The pipeline set up a subsidiary to enter into the formal purchase contract, thereby shielding itself from liability if the field's gas production proved to be smaller than anticipated. The pipeline also made a management contract under which one of the producers would perform most of the actual production work. The pipeline had substantial authority to make decisions about development of the field: it was empowered to determine whether new wells should be drilled and the volumes of gas to be nominated each month for production. Additionally, the Court found that "The gas reserves in Rayne Field were proven, and the field was substantially developed."[111]

After first regarding the lease-sale as nonjurisdictional, the Federal Power Commission had taken the position that the transaction fell within the scope of its regulatory powers under the Natural Gas Act. However, the Commission had refused to issue a certificate to permit consummation of the lease-sale, because the form of the transaction made it impossible to ascertain whether the price the pipeline would ultimately pay for the Rayne Field gas was in the public interest. The U.S. Court of Appeals for the Fifth Circuit had reversed the Commission's determination, holding that *Panhandle* placed the sale of leaseholds outside the FPC's regulatory jurisdiction.[112]

In reversing the Court of Appeals and holding that the lease-sale agreements were jurisdictional, the Supreme Court said:

> it is perfectly clear that the sales of these leases in * * * a proven and substantially developed field, accomplished the transfer of large amounts of natural gas to an in-

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[111] 381 U.S. at 396 (footnote omitted). There were 19 wells in being and 7 more yet to be drilled at the time the contract was closed.

[112] *Marr* v. *F.P.C.*, 336 F.2d 320 (5th Cir. 1964).

terstate pipeline company for resale in other States. *That is the significant and determinative economic fact.*[113]

The Court also emphasized that "to ignore [the economic equivalency of the lease-sale to a conventional wellhead sale] would substantially undercut *Phillips*. * * * "[114]

In *Rayne Field*, therefore, the Supreme Court established a functional approach to the problem of determining whether a transaction between an independent producer and an interstate pipeline amounts, in law, to a jurisdictional sale for resale of natural gas. What is important, under the Court's holding, is not the form of the transaction but whether it accomplishes substantially what a wellhead sale is intended to accomplish: the transfer of known, available reserves of natural gas to the pipeline.

In reaching that result, the Court in *Rayne* criticized its earlier *Panhandle* opinion, which had placed great reliance on the form of the transaction and had dismissed the difficult question of construing the substance of the transaction with the airy observation: "Of course leases are an essential part of production."[115] Such "flat statements," said the Court in *Rayne*, "should not be taken to cover more than the particular kind of leases that were before the Court [in *Panhandle*]; it should not be considered as embracing each and every transfer that can be put in lease form."[116] Hence, *Panhandle's* holding was limited strictly to its facts—the transfer by an interstate pipeline of leases covering an undeveloped field to a production company for ultimate sale and consumption of the gas in *intrastate* commerce.

In spite of the clarity with which the *Rayne* Court resolved the immediate issues before it, the Court nevertheless failed to

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[113] 381 U.S. at 401 (emphasis added).

[114] *Id.*

[115] 337 U.S. at 505.

[116] 381 U.S. at 404 (citation omitted).

delineate with any degree of specificity the standards by which economic equivalency, the hallmark of jurisdictional status, is to be determined. Nor did the Court tell us how substantial the development of a field must be before lease-sales may be deemed economically equivalent to jurisdictional sales of natural gas. Later courts were, therefore, compelled to use the factual setting in Rayne as a rough guideline. In *Rayne Field*, the Court pointed to: the fact that the lease-sale agreement was an alternate method of achieving the parties' intention to consummate a sale of natural gas; the pipeline's decisional role under the lease-sale arrangement (it had a major say in the scheduling of production); the existence of acceleration clauses which, in effect, tied the rate of payment to the rate of gas production; the use of an intermediate corporation to shield the pipeline from liability in the event production did not live up to expectations; the limited mineral rights conveyed by the lease-sale agreement (only natural gas and condensate were conveyed; the producers retained all oil rights); and the substantiality of development and proven condition of the field.

Bastian Bay[117] was a two-sentence, *per-curiam* opinion issued only six days after the *Rayne* decision. In the *Bastian Bay* case, the Supreme Court summarily reversed a Tenth Circuit decision which had held a substantially similar lease-sale agreement non-jurisdictional. Under the agreement, a producer conveyed its leasehold interests in a gas-producing field to an interstate pipeline. The $159 million in consideration was to be paid by means of a cash down payment at the time of execution of the agreement and the balance in notes, payable over a 17-year period. The price was based upon an estimate of reserves, but the agreement provided for redetermination of reserves and a consequent adjustment in the purchase price so as to keep the price per Mcf constant. The field was substantially developed at the time the contract was executed. The pipeline agreed to perform additional development and production

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[117] *F.P.C.* v. *Pan American Petroleum Corp.*, 381 U.S. 762 (1965).

work. In addition, the producer retained the rights to minerals other than natural gas.

It is thus apparent that many of the factors deemed determinative in *Rayne* were also present in *Bastian Bay*. A functional analysis of the lease-sale agreement in *Bastian Bay* leads to the same conclusion reached in *Rayne Field*; that is the reason for the Court's summary reversal, citing *Rayne*. It is equally clear, however, that certain factors present in *Rayne* are not of great weight since they did not exist in *Bastian Bay*. For instance, the Court of Appeals' opinion in *Bastian Bay* does not disclose the existence of any acceleration clauses which geared the payments to production. Nor was the *Bastian Bay* agreement specifically drafted as an alternate method of achieving the same objective as a preexisting wellhead sale contract, as was the case in *Rayne*.

In the *Ship Shoal* case, *Continental Oil Co.* v. *F.P.C.*,[118] the Fifth Circuit found a lease-sale agreement similar to those in the two earlier cases to be jurisdictional. In the process, the Court elaborated upon the functional approach laid down by the Supreme Court in *Rayne*. The Court of Appeals discerned a "three-pronged" test emerging from *Rayne*:

> (1) Is the economic effect of the transfer similar to that of a conventional [wellhead] sale? (2) Is the subject of the transaction "proven and substantially developed" reserves? (3) Is the transfer of the reserves for the purpose of interstate transmission and resale?[119]

The Court of Appeals noted that the *Rayne* test does not require an absolute identity between the lease-sale agreement and a conventional "wellhead" sale; some deviation is permitted. The "fundamental inquiry" is whether the transaction accomplished the transfer of sizeable amounts of natural gas from proven and substantially developed reserves to an in-

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[118] 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910 (1967).

[119] *Id.* at 62.

terstate pipeline for ultimate resale in interstate commerce.[120] The answer to this inquiry must, of necessity, be based upon a case-by-case analysis, in which the various relevant provisions contained in the leases, as well as the surrounding circumstances, are scrutinized to determine their economic effect.

The *Ship Shoal* case arose out of a factual setting remarkably similar to that of *Rayne* and *Bastian Bay*. The *Ship Shoal* producers developed offshore leasehold properties which they subsequently conveyed to an interstate pipeline for a lump-sum consideration, with the payments spread over 15½ years.[121] The parties had estimated the volume of recoverable reserves and had provided for a later redetermination of the reserve estimate and a concurrent adjustment of the purchase price to maintain the per-Mcf cost of the gas. While the transfer of leasehold interest purported to convey all mineral rights,[122] the pipeline, nevertheless, had the right to require the producers to purchase all crude oil production at a specified price.[123] The pipeline was to operate and manage the leasehold interests transferred.

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[120] *Id.*

[121] The pipeline agreed to pay over $97 million in cash, with a portion of the consideration to be paid at the execution of the lease-sale agreement. The bulk of the principal obligation was assumed by two subsidiary corporations, but a portion of that obligation was assumed by the interstrate pipeline company itself. The notes contained acceleration clauses, similar to those in *Rayne*, in which the payments were geared to production, "apparently as a security device." *Id.* at 63.

[122] The agreement transferred to the pipeline company the right to extract and sell the oil, casinghead gas, natural gas, condensate, and other natural gas liquids.

[123] The Court held that the producers' obligation to repurchase the oil produced was clearly "a signficant retained interest in Ship Shoal." *Id.* at 63. This option had been almost continuously exercised by the pipeline, which resold to the producers "virtually all oil taken from Ship Shoal." *Id.* The "economic effect" of this provision in the

The Court of Appeals refused to give decisive weight to the fact that the agreement was not a substitute transaction, as was the case in *Rayne Field*. The producers had invited offers from several prospective purchasers structured along the lines of either a lease-sale agreement of a conventional wellhead sale. The objective of the producers, the Court found, was to achieve the highest possible discounted cash flow, and any resulting difference among the various offers for sale or lease "goes more to the method of payment than to the substantial economic effect of the transfer."[124] In addition, the Fifth Circuit viewed the differences between the pipeline's operational and decisional role in the various contracts as "not substantial enough to defeat jurisdiction."[125] The Court thus concluded that the economic effect of the transfer was sufficiently identical to the conventional wellhead sale to satisfy the first part of the three-pronged test it had laid down.

Accordingly, the Court of Appeals determined that the economic effect of the *Ship Shoal* agreement was substantially similar to that of a conventional wellhead sale. The Court also found the level of development sufficient to satisfy the "second prong" of its *Rayne Field* test.[126] The Court reasoned that the basic standard is whether the leasehold interests have been "sufficiently proved and developed for [the] imminent production of natural gas in commercial quantities."[127] According to the Court, the two critical factors for ascertaining whether

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lease-sale agreement was to convey to the pipeline only the mineral rights to natural gas, condensate, and natural gas liquids. This was similar to the lease provisions in *Rayne* and to the "economic effect" of the agreement in *Bastian Bay*. The price to be paid by the producers for this oil was the average price posted in various South Louisiana fields. *Id.* at 60, 63.

[124] *Id.* at 62.

[125] *Id.* at 63.

[126] *Id.* at 63-66.

[127] *Id.* at 63-64. This was essentially the test promulgated by the *Rayne* Court in distinguishing *Panhandle*. Implicit in the distinction

commercial production is imminent are: (1) "definability of gas volume based upon proof of reserves;" and (2) the "imminent ability to produce in commercial quantities."[128]

In *Ship Shoal*, the parties who were appealing from the Commission's determination placed much emphasis upon the fact that only one gas well had been drilled on the acreage covered by the contract. The Court held that the *Rayne Field* doctrine was applicable nevertheless, and that the lease-sale amounted in law to a jurisdictional sale of natural gas for resale. First, the Court of Appeals noted that even though the parties' estimates of the field's reserves varied substantially, ranging from a low of approximately 530,000 MMcf by the pipeline to a high of approximately 823,000 MMcf by one of the producers, the parties were willing to stake considerable sums on a judgment that a very large volume of gas was *there*. The pipeline, the Court pointed out, "was willing to invest over $97 million in its faith in the lowest of the reserve estimates * * *."[129] In addition, the Court reasoned that, notwithstanding the paucity of actual drilling, the reserves were sufficiently proven and definable because—

> a definite and definable volume of gas cannot be determined down to the last cubic foot even after a well has been fully depleted. One can make only estimates of gas. There are some producing areas where it is possible to estimate recoverable reserves with a high degree of accuracy al-

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between undeveloped and substantially developed reserves lies the concept of "imminency of production." As the Supreme Court noted in *Rayne Field*.

> [T]he more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce which, as *Phillips* held, the Act has affirmatively placed within Commission jurisdiction.

381 U.S. at 403.

[128] 370 F.2d at 64.

[129] *Id.* at 65.

> though the particular leases are undrilled and undeveloped. In offshore fields and in South Louisiana, however, reserve estimates are more difficult to determine even after full development because of multiple formations and faulted reservoirs. The effect of redetermination provision is to negate or diminish substantially the shifting of the risk relating to gas deliverability from [the producers] to [the pipeline].[130]

The Court of Appeals in the *Ship Shoal* case also emphasized the pipeline's readiness to connect the field to its transmission system as a "strong indication that the field was 'substantially developed' at the time of transfer."[131] The Court pointed out that the pipeline had, in fact, included Ship Shoal reserves in papers supporting its applications for FPC certification to expand its facilities. The pipeline did so knowing that the FPC frequently conditioned certification upon actual operation of the facilities within one year. While "It may well be that Ship Shoal is a 'long way' from being fully developed * * * this * * * relates more to determination of final consideration, than to imminent ability for production."[132]

For these reasons, the *Ship Shoal* Court concluded that standards of definable gas reserves coupled with imminent ability to produce had been met sufficiently to satisfy the substantial development test of *Rayne Field*. It held, therefore, that the lease-sale transactions at issue were subject to the Commission's rate-regulation authority. The Court also concluded that a contrary holding would generate "an 'attractive gap' in the regulatory system * * * and the producing states would be unable to close it."[133]

The *Rayne Field-Bastian Bay-Ship Shoal* trilogy represented a major victory for the FPC. It firmly closed the door

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[130] *Id.*

[131] *Id.*

[132] *Id.* at 66.

[133] *Id.* at 67.

upon efforts to use the lease-sale contract as a device to evade the agency's jurisdiction over wellhead sales, including (most importantly) the agency's power to establish ceiling prices for all gas sold to the interstate market. Emboldened by its triumphs and persuaded that the *Panhandle* precedent had been permanently eradicated, the Commission decided to strike out against all lease transactions which contained market-value royalty clauses.[134] The Commission's position was that a lessor who claimed a royalty based upon the market value of the gas extracted from his land had an "economic interest" in the sale of the gas sufficient to invoke the principles established in *Rayne Field* and its progeny. The test case was Opinion No. 562,[135] in which the Commission, by a 3-2 vote, asserted jurisdiction over a group of lessors who had retained a market-value royalty, ruling that they had in fact "contracted to retain an economic interest in interstate sales, [and had] joined the other interest owners [the producers] in such sales, [thereby becoming] a seller of natural gas and therefore a natural gas company."[136]

The Commission's efforts in Opinion No. 562 were turned aside in *Mobil Oil Corp.* v. *F.P.C.*,[137] in which the Court held that the landowners' retention of a market-value royalty interest in a lease transferring natural gas reserves to a producer did not, *ipso facto*, render the landowner-lessor subject to the jurisdiction of the Federal Power Commission. Writing for the Court, Judge Leventhal reasoned that the lessor's economic

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[134] The effect of such a clause, if construed to entitle the lessor to a royalty based upon current intrastate gas prices could easily push the lessee-producer's royalty costs above the FPC-established ceiling price for gas of that vintage. At a mimimum, a market-value royalty would create volcanic pressures for higher prices. *Cf. F.E.R.C.* v. *Pennzoil Producing Co.*, 47 U.S.L.W. 4123 (January 16, 1979).

[135] 42 FPC 164 (1969).

[136] *Id.* at 172.

[137] 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972).

interest in the sale of the gas for resale in interstate commerce was insufficient, "standing alone and without any of the other attendant incidents of sale" to make the lease transaction jurisdictional.[138]

In *Mobil*, the gas reserves underlying the leased acreage were not proven, nor was the field substantially developed.[139] Additionally, the lease did not constitute the "economic equivalent" of a wellhead sale under the *Rayne Field* guidelines, the Court said.[140] Instead, the Court held, the lease involved in the case "is a transaction that is itself customary and conventional, one that precedes the 'conventional' sales in interstate commerce with which Congress was concerned * * *."[141] This type of landowner-lease transaction, the Court added, "indeed even precedes the 'production and gathering' which § 1(b) visualized as preceding the sale in interstate commerce over which jurisdiction was being established."[142]

The Court therefore determined that the lease before it was not the "economic equivalent" of a wellhead sale within the meaning of the traditional *Rayne Field* standards. The Court of Appeals went on, however, to resurrect the pre-interstate-movement/post-interstate-movement analysis of the *Panhandle* case, saying:

> the significant fact for a sale in interstate commerce is interstate movement either by the seller, prior to or in connection with the sale, or by the purchaser, typically an

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[138] *Id.* at 262-63.

[139] As the Court pointed out, the typical gas lease "transfers only the right to explore, develop, and market if exploration is successful; no royalty is paid if no gas is discovered." *Id.* at 262. This situation was distinguished from the ones in *Rayne Field*, *Bastian Bay*, and *Ship Shoal*, where the lease-purchaser's downside risk (*i.e.*, no gas or not much gas) was of a much different order of magnitude.

[140] *Id.*

[141] *Id.*

[142] *Id.*

> interstate pipeline company, subsequent to or in connection with the sale. In the case of a typical oil and gas lease, there is no such interstate movement by either the transferor or transferee.[143]

What this method of analysis misses, of course, is that the order of events, *e.g.*, whether interstate movement of gas precedes the execution of the formal documents (call them leases, assignments, or what you will), is commonly within the control of the parties to the transaction and, to the extent the Federal courts will sit still for it, can be rigged to fit within, or fall outside of, the Commission's regulatory jurisdiction in accordance with the parties' wishes. This is precisely the reason why the *Rayne Field* Court held that the order of events does *not* constitute a valid basis for finding a transaction jurisdictional *vel non*. For the author of *Mobil* to revert back to that long-discredited analytical test, even by way of *dictum*, may simply demonstrate that, on occasion, Homer nodded.

There is no question about the correctness of the result, of course, because the critical incidents of a conventional wellhead sale were clearly absent in the *Mobil* case. The landowner-lessors had no knowledge at the time the lease was executed of "the ultimate destination of any gas that might be discovered."[144] They did not know, and had no way of discerning, whether, assuming that gas proved to be present and producible in commercial volumes, the ultimate buyer of the gas would move it in interstate commerce, purchase it for resale, or purchase it for his own use. The lessors retained no control over any of the other incidents of a conventional sale: they could not select the purchaser; they could not determine or affect the price and quantity of any gas the producer might sell; and, as noted above, they had no say about whether the gas would flow to the interstate market or the intrastate market.

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[143] *Id.*

[144] *Id.*

For these reasons, the Court concluded that the landowner's lease was "too far removed from the interstate sale" to constitute a jurisdictional transaction.[145] It held that "an economic interest in the proceeds of a sale, unaccompanied by authority to determine the incidents of the sale, does not make one a seller."[146] By contrast, the producer-lessee would be a natural-gas company subject to regulation by the Commission, the Court said, "because of the interstate movement conducted either by him or by his company."[147]

The *Mobil* decision made it clear that the typical gas lease by a landowner does not bring the landowner within the ambit of the Commission's jurisdiction under the Natural Gas Act. It was also clear after *Mobil* that the landowner does not cross the jurisdictional boundary and become a natural-gas company merely because he retains a royalty that is dependent upon the volume or value of the gas produced, in the absence of power to determine any of the incidents of a wellhead sale.

What else may a landowner do and still elude the Commission's grasp? Not much, it develops—as a recent Fifth Circuit case made clear.

In *Louisiana Land and Exploration Co.* v. *F.E.R.C. (LL&E)*,[148] the Court had before it a landowner (Louisiana Land) which had reserved a fractional royalty interest (*i.e.*, a right to receive a royalty measured by a percentage of the value of the gas produced) when it had made a mineral lease of certain acreage to a predecessor-in-interest of Amoco Production Company (Amoco). The lease prohibited the transfer of the leasehold by the lessee or its successor-in-interest without the written consent of Louisiana Land.

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[145] *Id.* at 263.

[146] *Id.* at 262.

[147] *Id.* at 262, n. 15.

[148] 574 F.2d 204 (5th Cir. 1978), *cert. denied*, 47 U.S.L.W. 3495 (439 U.S. 1127, (1979)).

Subsequently, Amoco proposed to assign its interest in the lease to a jurisdictional natural gas pipeline, Tennessee Gas Pipeline Company (Tennessee). Tennessee was to pay a fixed sum per Mcf produced as consideration for the assignment. Amoco sought Louisiana Land's consent to the assignment. Louisiana Land gave its consent, but only upon condition that Tennessee would agree to transmute Louisiana Land's fractional royalty interest into the right to receive a fixed rate (severance taxes plus 22.5¢ and later 25.0¢) per Mcf of gas. Thus, the parties made a tripartite arrangement, under which Tennessee would produce the gas for injection into its interstate pipeline system and pay both Amoco and Louisiana Land royalties for the gas based directly on the volume of production.

The transaction between Amoco and Tennessee had been the subject of the Supreme Court's decision in *Bastian Bay*.[149] That case had held that the Amoco-Tennessee arrangement was a jurisdictional sale of natural gas under the *Rayne Field* doctrine. In *LL&E*, the Fifth Circuit held that Louisiana Land, the original landowner-lessor, was also engaged in a jurisdictional sale of gas to Tennessee and was required to secure Commission certification in order to do so lawfully.

Louisiana Land naturally relied heavily upon the *Mobil* precedent, contending that its activities were virtually identical with those of the landowner-lessor in that case. The Court of Appeals distinguished *Mobil*, however, pointing out that in the case before it, unlike the *Mobil* situation, the landowner, Louisiana Land, retained the power to block any further transfer of the leasehold rights. The Court expressly refused to decide whether the mere retention of such a power, without any subsequent exercise of it, is sufficient to render the lessor-landowner subject to Commission jurisdiction. Louisiana Land, however, *did* exercise its retained veto power by assenting to the transfer of the leasehold rights it had granted, by

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[149] *F.P.C.* v. *Pan American Petroleum Corp.*, *supra*, n. 117.

signing the agreement among the three parties, and, indeed, by exacting a price for its action. Louisiana Land's exercise of its retained power was, of course, essential in order to carry out the transfer of the gas to Tennessee. As the Court wrote,—

> The exercise of this power was an indispensable ingredient in an indisputably jurisdictional transfer. The exercise of this power was essential to accomplishing the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states and also affected an incident of the sale, the buyer's cost. Moreover, the exercise of the power, coupled as it was with an alteration of the royalty rate, had the effect of altering not only the cost of extracting the gas but also the cost of introducing the gas to commerce. Under these circumstances, we conclude that in economic effect [Louisiana] Land sold gas in interstate commerce subject to FERC jurisdiction. We hold that by retaining a royalty interest in gas extracted from premises leased to Amoco, retaining its power to prevent Amoco from selling its entire interest in proven and developed reserves to a pipeline company, and agreeing to an amendment of the terms of the royalty payments before consenting to the jurisdictional transfer, [Louisiana] Land made a jurisdictional sale of natural gas.[150]

The Court held, correctly, that the *Mobil* precedent mandated the result it reached in *LL&E*. In *LL&E*, the landowner was more than the passive lessor who was before the Court in *Mobil*. Instead, Louisiana Land has retained, and had exercised, authority that affected a number of the incidents of sale of natural gas. By doing so, Louisiana Land actively aided and abetted a concededly jurisdictional transaction. Although both parties started out on the same basis—landowners leasing their land for exploitation of its oil and gas—and both parties retained an economic interest in the exploitation of the land's natural gas reserves, only one of the landowners, Louisiana Land, also retained and exercised rights that affected the identity of the pipeline purchaser of the gas and

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[150] 574 F.2d at 207-08.

the price at which the pipeline purchaser secured the gas. Both of these rights were incidents of a garden-variety wellhead sale. Hence, Louisiana Land's actions placed it across the line that *Mobil* had drawn between the passive landowner-lessor and the active jurisdictional seller of natural gas for resale in interstate commerce. Thus, the result in *LL&E* is thoroughly consistent with the precedent of *Mobil*.

IX

The legal principles fashioned in the *Rayne Field* line of cases, when applied to the facts of this proceeding, lead inescapably to the conclusion that all of the lease-sale agreements at issue are jurisdictional. The crucial test that emerges from the cases is whether a particular transaction accomplished the transfer of large volumes of natural gas reserves to an interstate pipeline for resale in interstate commerce. If it did, the transaction is jurisdictional.

This is so regardless of the manner in which the transaction is structured. If *Rayne Field*, coming as it did after *Panhandle*, taught us anything, it was the necessity of eschewing the tyranny of labels and applying a functional analysis to lease-sale transactions in order to ascertain their jurisdictional character. This method of analysis is mandatory because to do otherwise would tend to frustrate the enacted public policy of the United States. The purpose of the Natural Gas Act, as interpreted in *Phillips*, was to regulate field sales of natural gas to interstate pipelines for resale in interstate commerce. If the format of the transaction rather than its substance (*i.e.*, whether it is cast as a wellhead sale, a lease assignment, or even, as we shall see, a farmout) were deemed critical to a determination of a transfer's jurisdictional character, ingenious lawyers, of whom this industry has little shortage, could surely find a way to evade the jurisdiction of the Federal regulatory agency.

Rayne Field established that such evasion of the purposes of the Act would not be permitted to occur, lest the objectives of Congress be completely and irretrievably thwarted. Six days

later, the Supreme Court in its *Bastian Bay* decision reaffirmed its intention not to permit the exaltation of form over substance to destroy the statutory scheme for regulation of field sales of natural gas.

The jurisdictional character of the contracts at issue in this proceeding follows almost *a fortiori* from the Court's holdings in those two cases and the Fifth Circuit's exegesis on them in *Ship Shoal*. In this context, it is significant that the contracts had their genesis over 30 years ago in the attempt by Delhi to evade Federal Power Commission jurisdiction by restructuring the Barker Dome transaction in the form of a lease-sale agreement. The restructuring of the agreement from a conventional wellhead sale to something apparently different, took place only after Delhi was thrice rebuffed by the FPC in its efforts to secure a declaratory order that the contemplated wellhead sale to El Paso would not render it subject to regulation under the Natural Gas Act. The Barker Dome dealings, though not directly at issue in this proceeding, probably represented a more blatant attempt to evade Federal regulation than the scheme which occurred in the *Rayne Field* case. And the results of the Barker Dome dealings set the pattern for the subsequent lease-sale agreements executed by El Paso and PNW. It is not surprising, therefore, to find that the intentions of the parties to the later agreements mirrored the motivations that shaped the earlier ones between Delhi and El Paso.

Although there were many different and unique features among the GLAs and the PLAs, a number of common threads run through all of them: the structuring of a rather typical gas purchase as a lease-sale agreement with the all-too-convenient effect of escaping Federal regulation (or so it was thought), and—most significantly—the transfer by a producer of large volumes of natural gas reserves ready to be extracted to an interstate pipeline for resale in interstate commerce.

There is no other rational explanation of what was going on. Putting to one side the fine-tuned, hairsplitting, sophisticated distinctions that the respondents are seeking to retail here (we

will come back to them later), a number of things stand out quite bluntly. First of all, the persons who acquired the leases and who sold them to El Paso and PNW were not real estate speculators. For the most part they were producers of natural gas who received their incomes from the sale of natural gas and other hydrocarbons. Secondly, the buyers were not wildcatters, gas and oil producers, or real estate investors. They were—or, in the case of PNW, soon would be—natural gas pipelines in the business of acquiring gas reserves in the field for long-distance transmission and wholesaling in major consuming markets. That is how they earned their incomes. There was no secret about this. Both buyers had, as all parties knew, an urgent need for the wherewithal to demonstrate the dedication of large new gas supplies to their systems in order to obtain regulatory approval for construction and expansion. And, as everyone knew, the new reserve additions could not be speculative. They had to pass muster as certain, sure, and proven before the certificates would issue, the facilities would be built, and (most important) the revenues would flow.

It will not do, therefore, to attempt to characterize the GLAs and PLAs as mere real estate deals between simple country gentlemen. Clearly, something else was afoot—a series of large-scale sales of natural gas in place. There can be little doubt of it.

The record also permits little doubt about the nature and character of the gas reserves transferred by virtue of the lease-sale agreements. At the time El Paso's lease-acquisition program got underway, and certainly by the time PNW began to acquire reserve commitments through lease-sale contracts, knowledgeable people—reservoir engineers and geologists working in the field—well understood that the San Juan Basin in general and, with only a few exceptions, the leaseholds involved in this case, constituted one of the major pools of untapped "gas in place" on the North American continent. It was well known that the Mesaverde formation consisted of blanket pay sands which were ripe for development and which could be expected to underlie virtually all of the respondents'

acreage. True, the cost of producing reserves in the Basin was thought to be somewhat higher than the cost of production elsewhere; that is what accounts for the fact that the interstate pipelines looked to the San Juan Basin only after other major gas producing areas, *e.g.*, the Permian and Hugoton Basins, had become major production centers. The later arrival of the interstate pipelines meant that full-scale development (drilling a well at every available location, for example) had not occurred in most cases by the time the GLAs and PLAs were closed.[151] But that degree of development was not to be expected. Nor is it required to support a finding that the lease-sales were jurisdictional, as *Ship Shoal* made clear. Upon consideration of all the evidence about the state of geological information, it is clear that the volumes of gas involved in this proceeding were definable within reasonable parameters, and that all of the leaseholds at issue here held reserves that were imminently producible in commercial quantities. Events bear out this analysis: shortly after the lease-sale agreements were closed, the acreage was developed, attached to the pipelines, and actually produced volumes of gas in quantities sufficient to supply the requirements of these major interstate natural gas pipelines.

The respondents answer to all of this is to invite the Commission to ignore the *Rayne Field-Bastian Bay-Ship Shoal* trilogy in favor of an atavistic reliance on *Panhandle* and its recent resuscitation in *Mobil*. These last two cases (coupled with some *dicta* in two Fifth Circuit cases[152]) are said to represent the applicable general rule which holds transfers of leases to be

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[151] But note that GLA 125 had more Pictured Cliffs wells on it when closed then it does today.

[152] *J. M. Huber Corp.* v. *Denman*, 367 F.2d 104 (5th Cir. 1966), and *Weymouth* v. *Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966). Both cases *held* only that the question whether a landowner's lease constituted a jurisdictional transaction was within the primary jurisdiction of the Commission.

nonjurisdictional. The *Rayne Field* line of cases, on the other hand, represents a narrow exception to the *Panhandle* doctrine that "leases are an essential part of production," claim the respondents, and should in effect be limited strictly to their facts. Hence, every possible distinction between the lease-sale agreements here involved and the contracts in *Rayne Field*, *Bastian Bay*, and *Ship Shoal* is recited in tedious detail as a basis for finding that the GLAs and PLAs were not economically equivalent to wellhead sales.

The respondents' arguments, in my judgment, stand the governing law on its head. Examination of the cases makes it clear that it is the *Mobil-LL&E* line of cases which represents an exception to the general rule set out in *Rayne Field*, *Bastian Bay*, and *Ship Shoal*, not *vice versa*. That category of exception relates to the jurisdictional status of landowners who make leases to entities in the business of exploring for, and developing, natural gas reserves. The transferors under the GLAs and PLAs, however, were not of the ilk of the landowner-lessors in *Mobil* and *LL&E*. For the most part, they were themselves producers and developers of natural gas reserves. Their dealings in gas-prone real estate have a considerably different cast than those of the landowners. And it follows that the basic premises of the *Mobil* decision do not apply to them. Instead, their rights and obligations are governed by *Rayne Field*, *Bastian Bay*, and *Ship Shoal*, all of which dealt specifically with sales or assignments of leasehold rights by parties situated similarly to the interest owners in this proceeding. Hence, the question which *Mobil* and *LL&E* deemed critical—whether the transferor retained and exercised the power to control the incidents of sale of the gas—is of only limited relevance here.[15a] What is significant is the

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[15a] Even if it were relevant, I would find that, under each of the lease-sale agreements, the interest owner retained sufficient control over the incidents of sale to render him jurisdictional under *Mobil-LL&E*. Since the interest owner was, in each case, dealing with the very pipeline that would acquire the gas for interstate transmission and sale for resale, it could hardly be otherwise.

essential message of *Rayne Field*—that the transfer of large amounts of natural gas reserves to an interstate pipeline for resale in interstate commerce is a jurisdictional transaction, no matter how the lawyers decide to structure the transfer. *Rayne's* specification that "proven and substantially developed reserves" must be present is not a quantitative test, a license for future courts and Commissions to engage in massive well counting in order to ascertain whether some formulaic criterion has been satisfied. Rather, *Rayne* is concerned with commercial realities. It asks whether what was sold was gas or merely the right to explore for and develop it in the uncertain event it is found.

In this context, the term "proven and substantially developed" plainly does not have the connotations with which the respondents would imbue it. They claim that the Supreme Court's use of that term sired a test which must be applied strictly, so that reserves cannot be deemed proven and substantially developed unless the acreage in question is the situs of nearly the maximum number of wells that the law will allow. Nothing else will do, according to the respondents.

In this case, they say, the reserve estimates by DeGolyer and MacNaughton were unreliable, and the geology of the Basin made reliable estimates unattainable in the absence of actual drilling for, and flowing of, gas reserves. The fact that the DeGolyer and MacNaughton reports established the existence of "proven" reserves to the satisfaction of the FPC, and the fact that other, contemporaneous, geological and engineering studies established the existence of "proven" reserves to the satisfaction of the bankers who financed the PNW pipeline are insufficient to establish the existence of "proven" reserves within the meaning of the *Rayne Field* test, according to the respondents. Similarly, the respondents claim that the field was not "substantially developed" for the purpose of the *Rayne* criterion. This omission, they claim, is demonstrated by

comparing a count of the wells extant at closing with the number of wells that were eventually drilled.[154]

From the standpoint of commercial realities, however, all of this is irrelevant to the question at hand: what were the transferees buying? In this proceeding, it is clear that the two pipelines were *not* buying the opportunity to explore several hundred thousand virgin acres in New Mexico and Colorado. They were in the market for gas reserves and nothing else. The critical factor, therefore (the proof of the pudding, as it were), is that these two pipelines were willing to stake large sums of money, their corporate fortunes, and, in one case, corporate viability itself, upon the proven and developed character of the acreage they acquired in the San Juan Basin. This is sufficient to satisfy the *Rayne Field* test.

In addition, as the *Ship Shoal* opinion noted, a requirement that the field must be fully mature as a source of gas production would lead to absurd results and would exclude from the *Rayne Field-Bastian Bay-Ship Shoal* rule the very fact situations that were before the Courts in those cases. The exact volumetric content of any field cannot be determined until after the field is actually producing in substantial volumes (and perhaps can never be known). A field will not actually be made to produce in substantial volumes until there is a pipeline connecting the field with gas markets. A pipeline will not be constructed until the pipeline company has acquired the contractual right to take sufficient reserves of gas from the field to make it worthwhile to incur the cost of construction. Once the pipeline company has acquired that right through wellhead sale contracts, it has no need to acquire the reserve commitments through lease-sale agreements. Hence, under the inexorable logic of the criteria that the respondents would have

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[154] In addition, respondents rely upon the fact that an infill drilling program in the Basin took place long after the acreage was transferred to El Paso and PNW and substantially increased the number of wells on the acreage.

the Commission apply, there would never be a case in which a pipeline would enter into a lease-sale arrangement that is jurisdictional. Yet, history teaches us that there have been such cases.

The respondents claim that the lease-sale agreements at issue in this proceeding are vastly different from the typical gas purchase contract and the type of contract involved in the *Rayne Field* case. They assert that the GLAs and PLAs "were tailored to meet special needs and circumstances which could not have been met by a sale of gas in place."[155] In an effort to buttress this assertion, the respondents point to a variety of provisions in the GLAs and PLAs that are not usually found in a conventional gas purchase contract and that were also absent from the *Rayne Field* contracts. Contrariwise, the respondents point to a number of provisions in the *Rayne* contracts that are absent from the GLAs and PLAs. Respondents urge that these differences among the two groups of agreements bespeak differences in the assumption of economic risks by the parties and conclusively demonstrate that none of the GLAs and the PLAs can be regarded as the economic equivalent of a jurisdictional sale, whether the sale takes the form of a conventional wellhead sale or a *Rayne*-type sale of gas in place.

One difficulty with this argument is that it asks the impossible. Rarely are two contracts exactly the same in all respects. The likelihood that two different sets of negotiators will make two identical contracts is virtually nil. It is equally clear that the Supreme Court in *Rayne* did not sit to construe the contract involved in that case and none other. The *Rayne Field*, *Bastian Bay*, and *Ship Shoal* contracts, all of which were held jurisdictional under judicial scrutiny, differed in many respects.

Even the GLAs and PLAs themselves differ in their terms. For purposes of the *Rayne Field* rule, however, these varia-

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[155] Initial Brief of Designated Respondents, p. 48.

tions are minor and insignificant in the overall perspective. As the Supreme Court noted,

> There are differences, to be sure, between the original [wellhead] sale agreements and the lease-sale plan * * *. But it is perfectly clear that the sales of these leases in Rayne Field * * * accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States. *That is the significant and determinative economic fact.*[156]

Here, too, the significant economic fact that will not go away no matter how much the respondents try to wish it away is that the GLA and PLA contracts at issue, each and every one of them, transferred large volumes of natural gas from a producer of natural gas to an interstate natural gas pipeline for transmission and sale for resale in other states. That fact requires the finding that each of the contracts was, as a matter of law, economically equivalent to a wellhead sale of natural gas for resale in interstate commerce.

One of the respondents' main lines of defense in this proceeding was that they were compelled by circumstances to enter into the lease-sale agreements which we know as GLAs and PLAs. Essentially, it is their position that El Paso, alone and later in combination with PNW, enjoyed a monopsonistic position in the San Juan Basin during the period when the agreements were negotiated. They claim that because of their vastly superior bargaining power as the only major pipelines in the Basin (and hence the only possible market for substantial volumes of natural gas), these two pipelines were able to dictate the going price being offered for wellhead sales. The price the pipelines set, it is said, was too low to enable the producers profitably to develop and produce the reserves underlying their leases. Hence, the producers conclude, they had no realistic option except to accede to the pipelines' offers to enter into lease-sale transactions. The respondents also

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[156] 381 U.S. at 401 (emphasis added).

contend that it was the *pipelines* that insisted on lease-sale acquisitions, knowing that, because their rates were regulated on a cost-of-service basis, they could simply pass the relatively high cost of San Juan Basin production along to the ratepayers.

The record does not, however, support the assertion that either El Paso or PNW, or both, possessed monopsonistic market power in the San Juan Basin during the relevant period. All that the record shows is that El Paso was the sole major interstate pipeline whose facilities had reached the Basin for a period, until the entry of PNW, after which there were two.[137] This is, however, a far cry from the showing that the respondents claim. There is simply no substantial evidence that the bargaining power of the pipelines, alone or in combination, was any greater than the bargaining power of the interest owners. If the record shows anything on this point with clarity, it indicates that El Paso and PNW were the parties who were desperate to make a deal, since they had an urgent and immediate need for gas reserves to support the applications which they had pending before the Federal Power Commission throughout the relevant period.

Furthermore, the argument, even if one grants its factual premise, proceeds from an erroneous conception of the law. The respondents would have the Commission hold that an otherwise jurisdictional lease-sale arrangement ceases to be jurisdictional because the seller would have preferred to make a conventional wellhead sale and was compelled to enter into the lease-sale by the overweening power of the buyer. This is

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[137] There were some local outlets for gas sales—*e.g.*, Southern Union Gas Company purchases for the intrastate market, minor purchases for field use—even before El Paso reached the San Juan Basin. The volumes demanded by these buyers were too small to constitute a significant market for the Basin's producers, however. In asserting that large-scale production could not take place until major interstate pipeline facilities arrived in the Basin the respondents are quite correct.

simply neither logical nor correct. Under *Rayne Field*, it is the economic effect of the transaction which is the touchstone of jurisdictional status. The motives with which the parties consummated the arrangement are irrelevant. Hence, even if we assume, *arguendo*, that the pipelines compelled the interest owners to enter into the GLA and PLA contracts through some sinister machinations or the assertion of irresistible economic power, that finding would not detract one iota from the conclusion that the contracts were subject to the regulatory jurisdiction of the Commission under the Natural Gas Act.

Similarly, the respondents' persistent assertions that the pipelines have been guilty of immoral profiteering, gross violations of the antitrust laws, failure to live up to bargains which they welcomed in more halcyon days, and inconsistent (and possibly perjurious) statements to the Commission about the character of the lease-sale agreements are all irrelevant to the issues which must be decided in this proceeding. This is not an area of the law where there is one rule for the party who wears the black hat and another for the party who wears the white hat. The *Rayne Field* doctrine, in short, is not a rule which is dependent upon normative behavior. It applies regardless of the moral character of the party who is detrimentally affected by it. And when, as here, it renders lease-sale agreements jurisdictional, it falls, as the biblical rain from heaven, on the just and the unjust alike.[15a]

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Notwithstanding the conclusion that all of the lease-sale agreements at issue are jurisdictional sales of gas as a matter of law, there are some lease-sale arrangements which merit special attention. One is the group of GLAs that was the subject of the Federal Power Commission's Opinion No. 642. The other is GLA 62 between El Paso and Blackwood & Nichols Company.

[15a] *Matt.* 5:45.

As we have noted above,[159] Opinion No. 642 held, in effect, that the Natural Gas Act did not confer regulatory jurisdiction over nine GLAs between El Paso and the so-called *Webb-Turner* parties.[160] In the order initiating these proceedings, however, the Commission ordered that the jurisdictional issues previously decided in Opinion No. 642 should be relitigated and redetermined *de novo*.[161]

The *Webb-Turner* parties, who were somewhat less than overjoyed at the prospect, petitioned the Commission for rehearing, arguing that Opinion No. 642 was *res judicata* and that, in any event, the commission is now collaterally estopped from retrying *de novo* issues that had been decided in 1973, when Opinion No. 642 was issued. The Commission rejected both branches of the argument. It held that neither the doctrine of *res judicata* nor the principle of collateral estoppel precludes *de novo* review of the jurisdictional issues decided in Opinion No. 642.[162] The *Webb-Turner* parties sought judicial review of the Commission's action exposing them to relitigation of the jurisdictional issues that had been decided in Opinion No. 642. However, the Court of Appeals for the Fifth Circuit ruled that it would stay its hand pending the Commission's disposition of the merits of those issues in this proceeding.[163]

At the initial prehearing conference, counsel for William G. Webb *et al.*, announced that his clients would not present any

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[159] *Supra*, at mimeo 6-7.

[160] The specific agreements are identified in the table at mimeo pp. 30-33, *supra*.

[161] Order Instituting Proceeding, *supra* at mimeo p. 5, n.6, at mimeo p. 8.

[162] Order on Rehearing, *supra* at mimeo p. 7, n.14, at mimeo, pp. 4-6.

[163] See discussion at mimeo pp. 9-10, *supra*. The Court had consolidated the *Webb-Turner* parties' petition with other petitions seeking immediate review of the FPC's decision to send this proceeding to hearing and with the appeal from the District Court's judgment in *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 427 F. Supp. 963 (W.D.

evidence in this proceeding but would rely instead on Opinion No. 642.[164] True to their word, the *Webb-Turner* parties did not participate in the evidentiary hearing. They have, however, submitted a post-hearing brief, in which they reiterate their contention that the Commission is bound by the FPC's determination in Opinion No. 642 to hold that their lease-sale agreements are nonjurisdictional.

It would indeed be interesting to consider whether, and the extent to which, the Commission is bound to adhere to the view it took in Opinion No. 642 by virtue of the doctrines of *res judicata* or collateral estoppel or under principles of elemental fairness deriving their applicability from the Constitution, the Administrative Procedure Act, or both. For one thing, the relevant cases on the application of doctrines such as collateral estoppel to administrative proceedings are of relatively recent vintage.[165] And it is entirely possible that the rules that apply to an agency which, like the Board of Contract Appeals in the *Utah* case,[166] is acting purely in an adjudicative capacity do not apply to an agency which, like the Commission in this proceeding, is conducting an investigation for the purpose of ascertaining whether there has been a violation of the statute it is charged with administering.

Interesting though these questions may be, they are not proper subjects for discussion in this Initial Decision. That is the case because the Commission in its order instituting this

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Tex. 1977). Its September 6, 1978 order withholding decision apparently applies to all of the consolidated cases. On October 25, 1978, the Court of Appeals responded to a motion for clarification by saying that Webb "will, along with all other parties to [the FERC] proceeding, be affected and bound by the action of the Commission and, an appeal or review by this Court, by orders of this Court."

[164] Tr. 31.

[165] *E.g.*, *United States* v. *Utah Constr. & Mining Co.*, 384 U.S. 394 (1966).

[166] *Id.*

proceeding and in its order on rehearing thereof made it quite clear that, in its view, none of the preclusionary doctrines which accord finality to prior adjudication apply to the *Webb-Turner* parties in this proceeding. The Commission has, in short, affirmatively and definitely decided that the hearing and disposition of the jurisdictional issues affecting the *Webb-Turner* parties is to be *de novo* and on the merits. That being so, the Presiding Administrative Law Judge, under well-settled principles, is not at liberty to ignore or impugn the Commission's determination. He is bound by it.

Three things follow. First, the correctness of the position taken by the *Webb-Turner* parties can not, and will not, be treated in this Decision. Second, those parties, if they desire to press their arguments to final disposition, must put them again to the Commission on exceptions to this Decision.[167] Finally, the *Webb-Turner* GLAs must be weighed in the same balance as the other lease-sale contracts *sub judice*. Applying that standard to the *Webb-Turner* agreements, it is clear that they do not differ from the other GLAs and the PLAs in any significant, relevant respect. They, too, accomplished the transfer of natural gas to an interstate pipeline for resale in interstate commerce. Hence, I conclude that the *Webb-Turner* agreements are jurisdictional.

The jurisdictional character of GLA 62 between El Paso and Blackwood & Nichols Company is also governed by the rules generally applicable to the other lease-sale agreements at issue here. This is the case despite the efforts of the present interest owner, F.H.N., Ltd., to confer special, unique status upon this particular GLA.

Before El Paso came upon the scene, Blackwood & Nicols had acquired their rights to the acreage by executing a farmout agreement with one W. E. Alsup, the owner of four leases covering acreage in Rio Arriba County, New Mexico.[168] The

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[167] See 18 CFR 1.31.

[168] Under a farmout agreement, the owner of the working interest assigns it to some other party (the "farmee") who is presently willing

agreement provided for Alsup to assign to Blackwood & Nichols at least two of the nine tracts covered by his leases.[169] Alsup reserved an overriding royalty of 5% on all hydrocarbons produced. Blackwood & Nichols agreed to pay Alsup $15.62 per acre at the closing and promised to drill a Pictured Cliffs well on each tract. The agreement also gave Blackwood & Nichols the exclusive option to purchase the right to develop additional tracts, at the same price of $15.62 per acre and the same 5% royalty obligation, for three years after the date of closing.[170]

Ultimately, after having drilled two Pictured Cliffs wells (one of which was plugged and abandoned) and having expended some $220,000 on unsuccessful development operations, Blackwood & Nichols grew discouraged and sought to sell its rights in the Alsup properties to El Paso.[171] The result was GLA 62, under which Blackwood & Nichols assigned its entire interest in the Alsup farmout agreement to El Paso, reserving a per-Mcf overriding royalty similar to the type of royalty previously reserved by other GLA interest owners in the San Juan Basin.[172]

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to develop the acreage. Commonly, the farmee is entitled to retain all revenues from the sale of hydrocarbons extracted from the property until he has recovered his costs of developing it. After that point—termed "payout"—is reached, the farmer receives a fractional overriding royalty on all hydrocarbons produced from the acreage. He may be entitled to convert the royalty into a working interest.

[169] Exh. 2, "Letter from Blackwood & Nichols Co. to Mr. W.E.Alsup, dated April 30, 1951." The first tract was designated in the agreement. The second tract, which was to be selected by Blackwood & Nichols, was to be assigned at a later date.

[170] *Id.*

[171] Designated Respondents' Proposed Findings of Fact, Tab H, No. 20, p. 4. See also Responses of Complainants to Designated Respondents' Proposed Findings of Fact, Tab H, No. 20, p. 2.

[172] See Exh. 2, "Oil and Gas Lease Sale Agreement." The other terms of the lease-sale agreement were also similar to those executed by other interest owners during El Paso's GLA-acquisition program.

F.H.N., Ltd., the successor to the rights and obligations of Blackwood & Nichols, now contends that GLA 62 should be accorded special treatment. The gravamen of F.H.N.'s position is that because all that Blackwood & Nichols had to convey to El Paso was its interest as farmee under a farmout agreement, Blackwood & Nichols could not have possibly made a jurisdictional sale of gas in place.

Nowhere is it explained why the position of farmee is inherently inconsistent with the role of seller of natural gas to a pipeline for resale, however. To the contrary, since no party to a farmout can receive any revenue unless gas produced from the acreage is sold, it would seem self-evident that the farmee, as the party empowered to exercise the working interest, has every right to sell the gas. Unless there is something in the farmout agreement which prohibits him from doing so (and no such provision has been cited to me), the farmee would be at liberty to negotiate and consummate a sale of the gas in place, just as he would be empowered to make a conventional wellhead sale of the gas. The fact that there are other parties with an interest in the leasehold who are not privy to the farmee's dealings with the pipeline purchaser does not in any way detract from the capacity of the farmee and the pipeline, by virtue of their agreement, to make a sale for resale that is subject to all of the provisions of the Natural Gas Act, thereby binding all interested parties.[173] There is, in short, no magic in the term "farmout" or in the status of "farmee" that would warrant different treatment for GLA 62 than for the lease-sale agreements.

Accordingly, I hold that, notwithstanding its unusual origins, and even though it is not technically a "lease" - sale, GLA 62 as a matter of law accomplished a sale of natural gas for resale in interstate commerce and is therefore subject to regulation under the Natural Gas Act.

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[173] *Cf. California* v. *Southland Royalty Co.*, 436 U.S. 519 (1978).

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For the foregoing reasons, I find that the lease-sale agreements between the respondents and the complainants constituted sales of natural gas for resale in interstate commerce. As those sales were made without certificates of public convenience and necessity and, in many instances, at rates exceeding the just and reasonable rates prescribed by the Federal Power Commission and the Federal Energy Regulatory Commission, the parties to the lease-sale agreements are subject to sanctions and remedies as provided by the Natural Gas Act.

WHEREFORE, *It is ordered*, subject to review by the Federal Energy Regulatory Commission on appeal or upon the Commission's own motion as provided in the Commission's Rules of Practice and Procedure, that such further and additional hearings as are necessary shall be held for the purpose of determining, in accordance with the Administrative Procedure Act, the sanctions that shall be applied and the orders the Commission shall enter to provide appropriate remedy for the violations of the Natural Gas Act specified above.

ISAAC D. BENKIN,
Presiding Administrative Law Judge.

4. OPINION OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TEXAS, *EL PASO NATURAL GAS CO.* V. *SUN OIL CO.*, 426 F. SUPP. 963 (JANUARY 27, 1977)

UNITED STATES DISTRICT COURT,
W.D. TEXAS, MIDLAND-ODESSA DIVISION.
JAN. 27, 1977

No. MO-74-CA-57.

EL PASO NATURAL GAS COMPANY,
Plaintiff,

PACIFIC NORTHWEST PIPELINE CORP., *et al.*,
Intervenors,

v.

SUN OIL COMPANY, *et al.*,
Defendants.

Producer of natural gas for interstate market to which certain working interests in oil and gas properties had been transferred under gas lease agreement brought action for declaratory judgment that the owners of the working interests transferred to producer must first seek certification from Federal Power Commission before they could collect overriding royalties in excess of regulated interstate rate. The District Court, Suttle, J., held, inter alia, that the agreements at issue were not sales in interstate commerce of natural gas for resale within meaning of Natural Gas Act, that there had been no violation of Act and that court lacked jurisdiction over subject matter.

Case dismissed.

Paul R. Connolly, J. Alan Galbraith, William E. McDaniels, Williams, Connolly & Califano, Washington, D.C., Charles Sapp, W. Robert Brown, Liddell, Sapp, Zivley & Brown, Houston, Tex., Richard S. Morris, Harris S. Wood, El Paso Natural Gas Co., El Paso, Tex., for El Paso Natural Gas Co.

David K. Watkiss, Watkiss & Campbell, Salt Lake City, Utah, Daniel F. Collins, Ross, Marsh & Foster, Washington,

D.C., James M. O'Leary, Shafer, Gilliland, Davis, Bunton & McCollum, Odessa, Tex., for intervenor, Northwest Pipeline Corp.

Rufus G. Thayer, San Francisco, Cal., for intervenor, People of the State of Cal. and Public Utilities Commission of the State of Cal.

Thomas F. Brosnan, John F. Harrington, Gallagher, Connor & Boland, Washington, D.C., for intervenors, Tucson Gas & Elec. Co., Washington Natural Gas Co., Southern Union Gas Co.

Leonard L. Snaider, C. H. McCrea, Las Vegas, Nev., for intervenor, Southwest Gas Corp.

Howard V. Golub, Donald L. Freitas, San Francisco, Cal., Jack Q. Tidwell, Deaderick, McMahon, Cox, Todd & Tidwell, Odessa, Tex., for intervenor, Pacific Gas & Elec. Co.

Ed M. Cage, Herf M. Weinert, G. David Neal, Dallas, Tex., Leo J. Hoffman, Strasburger, Price, Kelton, Martin & Unis, Dallas, Tex., W. B. Browder, Jr., Stubbeman, McRae, Sealy, Laughlin & Browder, Midland, Tex., for Sun Oil Co.

George B. Mickum, III, Steven H. Brose, Steptoe & Johnson, Washington, D.C., Edward J. Kremer, Jr., Horace N. Burton, Dallas, Tex., W. B. Browder, Jr., Midland, Tex., for Atlantic Richfield Co.

Robert D. Haworth, Mobil Oil Corp., Houston, Tex., Philip R. Ehrenkranz, Craig W. Hulvey, Grove, Jaskiewicz, Gilliam & Cobert, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Mobil Oil Corp.

W. A. Schneeberg, American Petrofina Co. of Texas, Dallas, Tex., Gordon Gooch, Charles M. Darling, Baker & Botts, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for American Petrofina Co. of Texas.

James J. Dawson, Gene Burke, Cable, McDaniel, Bowie & Bond, Baltimore, Md., Gordon Gooch, Washington, D.C.,

W. B. Browder, Jr., Midland, Tex., for Crown Petroleum Corp.,

Edward Kliewer, Jr., Kliewer & Hood, Dallas, Tex., Gordon Gooch, Washington, D.C., for Delta Drilling Co. (Delta Drilling Corp.)

Dee H. Richardson, Union Oil Company of Cal., Midland, Tex., Platt W. Davis, III, Michael J. Henke, Vinson, Elkins, Searls, Connally & Smith, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Union Oil Co. of Cal.

Lionel E. Z., Cohen, Tulsa, Okl., Gordon Gooch, Washington, D.C., for Mr. and Mrs. Morris Mizel.

Vernon M. Turner, Houston, Tex., Millard F. Carr, Tenneco Corp., Denver, Colo., Gordon Gooch, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Tenneco Corp.

Thomas H. Burton, Jr., Continental Oil Co., Houston, Tex., Gordon Gooch, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Continental Oil Co.

W. B. Browder, Jr., Midland, Tex., for W. Watson LaForce, Jr., et al.

MEMORANDUM ORDER

SUTTLE, District Judge.

This is a suit under the Natural Gas Act of 1938.[1] Its genesis is in the differential between the unregulated price of intrastate gas and the regulated price of interstate gas. El Paso Natural Gas Company produces natural gas for the interstate market. Plaintiffs claim that the Defendants must first seek certification from the Federal Power Commission (FPC) before they can collect overriding royalties in excess of the regulated interstate rate. Plaintiffs seek a declaratory judgment[2]

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[1] 15 U.S.C. § 717 *et seq.*

[2] El Paso originally sought declaratory relief in the United States District Court for the District of Columbia. El Paso brought suit after Sun was awarded a 40 cent per Mcf overide. (See Finding of Fact 16,

that Defendants are natural gas companies selling gas for resale in interstate commerce. The suit reduces to the following proposition.[3]

> Where certain agreements, by which lessees transferred working interests in oil and gas properties to a regulated pipeline, provided for payments of overriding royalties on a scale initially set at a certain number of cents per Mcf of production and escalated that amount per Mcf over an initial term of years, and provided for arbitration of the amount of payments after the initial term if the parties were unable to agree on the amount, and where a subsequent arbitration award placed the amount of the override payments in excess of the FPC regulated price, are those agreements "sale[s] in interstate commerce of natural gas for resale" within the meaning of § 5 of the Natural Gas Act of 1938 (15 U.S.C. § 717d)?

Since this Court's jurisdiction coincides with the FPC's jurisdiction over "sale[s] in interstate commerce of natural gas for resale," from January 21 to March 4, 1976, this Court heard evidence to determine its jurisdiction.[4] Between April 23 and April 27, 1976, the Court heard arguments on the evidence. On

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infra). As the other Defendants sought to increase the level of their overrides, (See Finding of Fact 17, *infra*) El Paso brought individual actions against each of these Defendants. The United States District Court for the District of Columbia consolidated all those individual cases. The consolidated case was transferred to the Western District of Texas under the provisions of 28 U.S.C. § 1406.

[3] Contract analysis would reduce the case to the following proposition:

> Does El Paso bear the risk of the FPC determining that the level of overrides is unjust and unreasonable, or do the Defendants bear that risk?

See Initial Decision on Disputed Issues (FPC Docket RP73-109, *et al.*, opinion issued September 29, 1976). A determination that Defendants were "natural gas companies" would shift the risks of an adverse FPC determination to the Defendants.

[4] 15 U.S.C. § 717u; *see* 15 U.S.C. §§ 717c(a), (c); 717a(6); 717(b).

November 22, 1976, the Court heard arguments on the law. The Court concludes that it lacks jurisdiction and enters the following findings of fact and conclusions of law.

FINDINGS OF FACT

(1) Plaintiff El Paso Natural Gas Company (El Paso), a regulated interstate pipeline, is producing natural gas from its own leases in the San Juan Basin (Basin). In July 1950, the FPC certified El Paso to build a natural gas transmission line from the Barker Dome Field in the Basin to California. FPC certification established El Paso as the dominant economic force in the Basin, because El Paso, the only pipeline having access to interstate markets, was the only potential purchaser of Basin gas. After certification, El Paso acquired extensive leasehold interests in the Basin,[5] including the leaseholds involved in this litigation. All the agreements at issue in this case were executed after El Paso had completed its transmission line.

(2) The Defendants were originally lessees[6] holding working interests in certain oil and gas properties in the Basin. Under agreements denominated Gas Lease Agreements (GLAs) the Defendants transferred certain of their working interests to El Paso.

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[5] Because the Barker Dome transaction (GLA-32) was negotiated before El Paso was certified, the history of the Barker Dome agreement is not analogous to the agreements here at issue. In any regulated industry, entry into the market through certification is probably the most critical step. The negotiations surrounding Barker Dome reflect El Paso's efforts to enter the San Juan Basin. Once El Paso was certified, it held a virtual monopsony in the Basin since Southern Union Gas Company, the only other pipeline in the Basin, served only intrastate markets which were already fully utilized.

[6] Defendants in many instances are successors-in-interest to the original lessees who negotiated the GLAs. Because being a successor-in-interest is of no legal significance, the current interest holders are treated as having been the original lessees.

(3) The GLAs in issue (GLAs 47, 52, 60, 61, 63, 66, 76, 78, 106, 125, 129, 172, 348 and 349) provided that El Paso would receive the rights to develop and market natural gas in one or more productive formations.[7] The agreements typically provided[8] that:

(a) El Paso was obligated to drill each 320 acre drilling unit on the acreage transferred. If El Paso failed to drill a 320 acre unit, the unit reverted to the lessee.

(b) El Paso was obligated to pay for wells located on the property which met a certain specified productivity.[9]

(c) El Paso had the option of returning acreage which proved to be noncommercial.

(d) El Paso was obligated to make a minimum payment if the amount of overrides on gas produced were less than that minimum amount.[10]

(e) El Paso was obligated to pay an amount per Mcf that was equivalent to the amount El Paso paid for similar gas under similar agreements; i.e. a favored nations clause.

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[7] The Pictured Cliffs and the Mesa Verde were the formations most commonly transferred. GLAs 348 and 349 conveyed only interests in the Dakota formation because rights to the Pictured Cliffs and Mesa Verde in the same acreage had previously been conveyed by GLA-76. Certain agreements transferred fee leases instead of transferring productive horizons because the acreage was Indian tribal land which could not be transferred horizon by horizon.

[8] In GLAs 125 and 129 the lessee developed the properties and incidentally assumed the risks of dry holes. GLAs 125 and 129 provided the lessee with an option to transfer acreage to El Paso on a well by well basis. Both GLAs 125 and 129 had total production payments based on the estimated reserves of gas in place, and provided for the redetermination of reserves. (*See* Finding of Fact 20, *et seq.*, *infra*).

[9] GLAs 125 and 129 gave lessees options to transfer on a well by well basis. (See Finding of Fact 20, *infra*).

[10] GLA 63 had no minimum take or pay provision; instead, GLA 63 provided for a ratable take of gas.

(4) El Paso was obligated to pay an overriding royalty of a specified number of cents per Mcf of production. The amount to be paid per Mcf escalated over a fixed period of time (initial term). After the initial term expired, the amount of the override was to be redetermined by the parties. If the parties were unable to agree on the amount of the override payments, they were obligated to arbitrate.

(5) No agreement at issue specified an up-front payment tied to an estimate of reserves.[11]

(6) The San Juan Basin is a distinct geological entity located in the four corners area of New Mexico and Colorado. The Basin takes its name from its structure. In cross-section, the Basin is a bowl shaped depression. Formations lying several thousand feet below the surface at the center of the Basin rise to the surface at its edge. The surface outcrops of the formations mark the Basin's perimeter.

(7) Three formations in the Basin are gas productive.[12] From the shallowest to the deepest formations are the Pictured Cliffs, the Mesa Verde, and the Dakota. All three formations are tight in that each formation is characterized by low to moderate permeability and low porosity.

(8) Recovery of natural gas from each productive formation is a function of the variations in the permeability and in the porosity of the formation. Because the Basin's geologic structure does not reveal those variations in any productive forma-

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[11] The Barker Dome Agreement (GLA-32) provided for an up-front payment. *See United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392, 85 S.Ct 1517, 14 L.Ed.2d 466 (1965); *Federal Power Commission* v. *Pan American Petroleum Corp.*, 381 U.S. 762, 85 S.Ct. 1802, 14 L.Ed.2d 714 (1965); *Continental Oil Co.* v. *Federal Power Commission*, 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910, 87 S.Ct. 2114, 18 L.Ed.2d 1349 (1967).

[12] The productive area of each formation does not extend to its surface outcrop.

tion, geologic structure has little or no direct influence upon the localization of recoverable gas reserves. Actual drilling is the only method of locating recoverable gas saturations.

(9) Because the productive formations are tight, even where drilling located recoverable reserves, completed wells delivered gas in low volumes.

(10) Two consequences do flow from wells in the Basin because large volumes of gas do not. First, drilling costs are significantly higher because more wells have to be drilled to supply a pipeline with commercially significant volumes of gas. Second, where the drilling costs are recouped out of the volume of gas sold, those costs are recovered more slowly for wells of low deliverability than for those of high deliverability.[13]

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[13] For a specific leasehold a producer recovers the costs of drilling, including the costs of unsuccessful wells, by selling gas. In view of the low average deliverability of successful wells, the risks of unsuccessful drilling, the low prices El Paso offered for gas and the absence of any other buyer, no producer had any reasonable assurance of drilling commercial wells in the San Juan Basin.

El Paso, on the other hand, earned a rate of return on capital invested in successful wells. Since that capital account was depreciated on units of production, El Paso's capital accounts remained higher the more slowly successful wells delivered gas. El Paso was also able to expense the costs of unsuccessful wells. El Paso was able to pass the risk of unsuccessful drilling on to its customers.

> "Under this method [cost of service], the natural gas in place and the properties and equipment utilized in producing it are included in the rate base, along with the transmission, compression, and other facilities employed in transporting and selling it to the customers, at the net investment which they represent, *i.e.*, their original cost less the reserves that have been accrued to cover their depreciation and depletion. In addition to a rate of return thereon equal to the rate of return found reasonable for the pipeline operation overall, there are included in the recoverable costs of service, upon which the charges to jurisdictional customers are based, all operating expenses chargeable to production, including such uncapitalized exploratory and development outlays as delay rentals, geological surveys, and the ex-

(11) Some properties had no drilled acreage when the respective GLA was executed. For those properties that had drilled acreage when the respective GLA was executed, the number of wells drilled was quite small in relation to the number of drilling spaces available.

(12) During the 1950's and into the 1960's, El Paso spent substantial sums developing properties it had acquired in the Basin.

(13) During each GLA's initial term, El Paso paid the specified overrides for volumes produced from the respective properties.

(14) After initial term of each GLA had expired, El Paso continued to pay overrides at the highest rate set out in the original agreement.

(15) When, in 1973, the level of the override for GLA 61 was to be determined again, Sun Oil Company (Sun) and El Paso could not agree on the level of that override. The parties proceeded to arbitration.

(16) A Board of Arbitrators awarded Sun an override of a 40 cents per Mcf. The amount of the override was based on the wellhead value of gas. The Board calculated the wellhead value of gas using the market value of intrastate gas instead of the regulated interstate rate. This override award exceeded the FPC regulated price for San Juan gas of similar vintage.

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penses of drilling dry holes. Thus all the costs and risks incurred in the search for gas by a pipeline are shifted from (stockholders) to the customers of the pipeline. In addition, all expenses associated with the extraction of liquid hydrocarbons . . . are also included among the allowable operating expenses, but corresponding production credits are made of the revenue from the sale of such products. Under the rate-base approach allowances for taxes on the production property are made in accordance with the actual payments made thus transferring to the rate payer all the savings of federal income taxes permitted by statute to be enjoyed by gas producers through allowances made for depletion and intangible well drilling costs." (Opinion 568, 42 FPC 738, 756 (1969)).

(17) The interest holders under other GLAs at issue demanded an override of 40 cents per Mcf. They claimed that the arbitrator's award to Sun triggered the favored nations clauses in their own agreements.

(18) No Defendant sought a certificate from the FPC before asserting his right to collect a 40 cent per Mcf override.

(19) In its rate cases El Paso had always treated the volumes of gas produced from the properties at issue as having been produced from its own properties and never as having been purchased under gas sales contracts.

(20) GLA-125 interest holders began receiving overrides after excercising options to transfer producing wells to El Paso. The interest holders sought certificates of abandonment from the FPC, because prior to exercising those options they had been selling gas to El Paso under gas sales contracts.[14]

(21) El Paso was a party in the *Webb-Turner*[15] litigation. When El Paso took over the GLA-125 leases, El Paso sought to include in its rates its actual costs for producing gas from the GLA-125 properties. El Paso's production costs were higher than the area rates. The Staff of the FPC and the State of California claimed that El Paso was entitled only to area rates for the gas produced on GLA-125 properties. Their theory was that GLA-125 was actually a gas sales contract like *Rayne Field*[16] and that the transaction should be considered a sale of gas.

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[14] *Webb-Turner*, Opinion 642, 49 FPC 17 (1973).

[15] *Id.*

[16] *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965).

(22) After litigation of the issue, the FPC concluded that El Paso could include its actual costs in its rate rather than being limited to the lower area rates because:

> "the . . . transactions [GLA-125] should not be considered equivalent to *Rayne* transactions because they arose under different circumstances. . . ."[17]

The opinion specifically found that GLA-125 differed from *Rayne Field* in that GLA-125 did not transfer proven and substantially developed acreage:

> ". . . there was a transfer of natural gas in the form of reserves to an interstate pipeline company for resale, but the transactions here represented a method evolved by El Paso and the Producers to cause the exploration for and the development of necessary gas supplies. By entering into the option agreements, El Paso was not buying developed reserves but arranging to have certain leases in the San Juan explored and developed by the producing interests, who were given an option to transfer the leases to El Paso provided the wells met initial productivity tests specified in the option agreements."[18]

No appeal was taken from the decision.

(23) The GLAs in issue were not transfers of leases with proven reserves, since no reasonable estimate of recoverable reserves underlying the specific acreage conveyed could be made at the time its respective GLA was executed. Because insufficient drilling had been done to prove up reserves in the specific acreage transferred, the GLAs in issue were not agreements to transfer definable volumes of reserves. Actual drilling was the only method of locating and defining recoverable gas saturations on specific acreage.[19]

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[17] 49 FPC at 26.

[18] *Id.*

[19] When El Paso increased its transmission facilities, El Paso, its creditors and the FPC were relying on the conclusion of DeGolyer & McNaughton (D&M) that plenty of gas existed in the Blanco-Largo

The GLAs themselves indicate that the parties negotiated for acreage containing unproven reserves. First, each GLA granted El Paso the option of returning drilling sites that proved to be uncommercial. Second, no GLA provided for an up-front payment based on an estimate of recoverable reserves. Even though El Paso was bargaining from a superior position, had the parties been bargaining for proven reserves, up-front payments and no option to return would have been included in the GLAs.

(24) Because little if any actual drilling had been done on any acreage when its respective GLA was executed, each GLA was an agreement to transfer acreage which was not substantially developed. Where wells had been drilled, the number was exceptionlly low compared to the number of available drilling sites. Wells in the Basin generally were incapable of recovering commercially significant amounts of gas. Not only were these wells generally of such low deliverability that a producer could not hope to recoup his drilling costs, but also a significant amount of drilling remained to be done to supply a

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field. D&M's analysis implied that over the entire field commercially recoverable accumulations of natural gas existed. The most that could be inferred from D&M's analysis, however, was that over the entire field there would be an average rate of success in drilling for commercially recoverable accumulations of natural gas. The report did not show, nor coult it be inferred from D&M's analysis wheher or not specific acreage would contain commercially recoverable reserves; i.e. proven reserves.

The D&M report points out the qualitative difference in the risk of drilling undertaken by El Paso, apart from El Paso's ability to pass that risk on (*see* note 13 *supra*) and that undertaken by any other producer. The more acreage El Paso developed in the Basin the closer it could come to D&M's average recovery rate (assuming D&M to be correct). Any other producer had a higher risk than El Paso because he took the drilling risks on a limited amount of acreage, and was simply not in a position to spread his risks over the entire field to insure an average recovery rate.

pipeline with commercially significant volumes of gas. The GLAs themselves indicate that the parties negotiated for undeveloped acreage. El Paso undertook extensive burdensome development obligations.[20] El Paso's offer of equivalent payments for gas acquired under purchase contracts as for overrides on gas produced under the GLAs was an inducement to the lessees to shift development of their acreage to the pipeline. Each transaction made sense economically, only if undeveloped acreage were transferred, because El Paso was, in effect, trading on its status as a utility regulated on the "cost of service" basis.

(25) The GLAs were not the economic equivalents of gas sales contracts. The parties did not enter into the GLAs as a means of shifting payments as in *Rayne Field*. Rather, these agreements arose from the unique economic situation of the parties and reflected their efforts to structure the transactions so that El Paso would explore for and develop gas reserves in the Basin. The structuring of the economic risks and benefits between the parties more closely resembles the reallocation of risks and benefits in a farm-out than in a gas sales contract. The overall economic effect of the GLAs cannot be judged by merely looking to the ultimate purchaser of gas—the consumer—to see what price he pays. Were that reduction followed blindly, all gas transactions would be equivalent to gas sales contracts, since it is an irreducible economic fact that a consumer will pay for gas he uses.

(26) Plaintiff-Intervenor Pacific Northwest Pipeline Corporation (PNW) is a regulated interstate pipeline. PNW is successor in interest to certain El Paso properties.[21]

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[20] In GLAs 125 and 129 the lessee undertook the risk of development. (*See* Finding of Fact 20, *supra;* note 8, *supra*).

[21] *See United States* v. *El Paso Natural Gas Co.*, 358 F.Supp. 820 (D. Colo. 1972), *aff'd*, 410 U.S. 962, 93 S. Ct. 1440, 35 L.Ed.2d 697 (1973).

(27) Defendant Mobil Oil Corporation (Mobil) was originally a lessee of certain Basin properties located in Colorado. Mobil transferred these leases to PNW in an agreement denominated a Pacific Lease Agreement (PLA-13). PNW undertook a substantial drilling obligation when it signed PLA-13. At the time of transfer PLA-13 acreage was believed to be on the northernmost fringes of the Mesa Verde production area.

(28) PLA-13 is almost identical to the GLAs in issue here. PLA-13 differs in one significant respect from the GLAs. After the expiration of the initial term PLA-13 provides the amount of override is to be determined by a mechanical formula rather than by agreement or by arbitration.

(29) At the time PLA-13 was executed, no wells had been drilled on the acreage. A few wells had been drilled on adjacent acreage.

(30) The acreage conveyed by PLA-13 was not proven when PLA-13 was executed.

(31) The acreage conveyed by PLA-13 was not substantially developed when PLA-13 was executed.

(32) PLA-13 was not the equivalent of a gas sales contract.

(33) The gas produced from each of the agreements in issue traveled in interstate commerce.

CONCLUSIONS OF LAW

1. Because no agreement was the economic equivalent of a gas sale contract, and because the leases transferred were neither proven nor substantially developed at the time of the execution of those agreements, each agreement at issue in this litigation [GLAs 47, 52, 60, 61, 63, 66, 76, 78, 106, 125, 129, 172, 348, 349, and PLA-13] is not a "sale in interstate commerce of

natural gas for resale" within the meaning of Section 5 of the Natural Gas Act of 1938.[22]

2. No Defendant in this litigation is a "natural gas company" within the meaning of the Natural Gas Act because that Defendant claims an interest under an agreement in issue.[23]

3. The failure of each Defendant to seek certification from the FPC to collect overrides does not constitute a violation of the Natural Gas Act since no Defendant had a legal duty to seek such certification.[24]

4. Because the fact that leases transferred pursuant to GLA-125 were neither proven nor substantially developed was an ultimate adjudicatory fact necessarily decided in the *Webb-Turner* proceeding when El Paso sought to include its actual costs in its rates, because that fact was actually litigated by El Paso against the contentions of the Staff of the Federal Power Commission and the State of California, and because the *Webb-Turner* decision is now final, under the principle of collateral estoppel,[25] El Paso is precluded from relitigating the fact that

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[22] 15 U.S.C. § 717(b); *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965); *Federal Power Commission* v. *Pan American Petroleum Corp.*, 381 U.S. 762, 85 S.Ct. 1802, 14 L.Ed.2d 714 (1965); *Federal Power Commisson* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949); *Continental Oil Co.* v. *Federal Power Commission*, 370 F.2d 57 (5th Cir. 1966); *cert. denied*, 388 U.S. 910,87 S.Ct. 2114, 18 L.Ed.2d 1349 (1967); *Mobil Oil Corp.* v. *Federal Power Commission*, 149 U.S. App.D.C. 310, 463 F.2d 256 (1971), *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 *reh. denied*, 409 U.S. 903, 93 S.Ct. 103, 34 L.Ed.2d 166 (1972).

[23] 15 U.S.C.. § 717a(6).

[24] 15 U.S.C. § 717c(a), (c).

[25] *Blonder-Tongue Laboratories, Inc.* v. *University of Illinois Foundation*, 402 U.S. 313, 91 S.Ct. 1434, 28 L.Ed.2d 788 (1971); *Tampa Phosphate R. Co.* v. *Seaboard Coast Line R. Co.*, 418 F.2d

the GLA-125 leases were neither proven nor substantially developed.

5. This Court lacks jurisdiction over the subject matter because there has been no violation of the Natural Gas Act.[25]

6. This Court in its sound discretion declines to continue to exercise its pendent jurisdiction over the state contract claim still pending between PNW and Mobil. Although dismissal will cause some inconvenience to the litigants, to decide the claim would involve the Court in a determination of substantive Colorado law affecting real property located in Colorado. The interest that the State of Colorado has in deciding matters concerning real property located in Colorado, and the peculiar competency of Colorado State Courts to resolve such issues force this Court to conclude that to decide the issue would be an abuse of its discretion.[27]

The Court therefore ORDERS:

That this case be dismissed against all Defendants for want of jurisdiction.

That the costs be shared by all Plaintiffs and Intervenors equally.[28]

The Clerk is instructed to enter judgment.

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387 (5th Cir. 1969), *cert. denied*, 397 U.S. 910, 90 S.Ct. 907, 25 L.Ed.2d 90, *reh denied*, 397 U.S. 1030, 90 S.Ct. 1256, 25 L.Ed.2d 543 (1970).

[25] 15 U.S.C. § 717u.

[27] *See Moor* v. *County of Alameda*, 411 U.S. 693, 710, 93 S.Ct. 1785, 36 L.Ed.2d 596 (1973).

[28] 28 U.S.C. § 1919.

5. ORDER OF THE COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC*, 580 F.2d 722 (September 6, 1978)

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

Sept. 6, 1978

Nos. 77-2613, 77-2755, 77-2759, 77-2761, 77-2790, 77-2803, 77-2845, 77-2861 and 77-1762.

TENNECO OIL COMPANY and Continental Oil Company, *et al.*, *Petitioners*,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *Respondent*.

EL PASO NATURAL GAS COMPANY, *et al.*, *Plaintiffs-Appellants*,

v.

SUN OIL COMPANY, *et al.*, *Defendants-Appellees*.

Natural gas producer to which certain working interests in oil and gas properties had been transferred under gas lease agreement brought action for declaratory judgment that owners of working interests transferred to producer were required to first seek certification from Federal Energy Regulatory Commission before collecting overriding royalties in excess of regulated interstate rates. The United States District Court for the Western District of Texas, Dorwin W. Suttle, J., 426 F.Supp. 963, dismissed action, and gas producer's appeal was consolidated with petitions for review of Commission's orders in related proceedings. The Court of Appeals held that it would withhold decision pending receipt of Commission's decision in related administrative proceeding which raised the same substantive question of whether natural gas lease-sale agreements were sales of gas in interstate commerce within meaning of Natural Gas Act.

Order accordingly.

Gordon Gooch, Washington, D.C., for Tenneco Oil Co., et al., Crown Central Petroleum, and Morris Mizel, et al.,

Leo J. Hoffman, Dallas, Tex., for Sun Oil Co. (Del.).

Robert D. Haworth, Houston, Tex., for Mobil Oil Corp.

W. B. Browder, Jr., Midland, Tex., for W. Watson LaForce, Jr., et al.

Sherman S. Poland, Washington, D.C., for William G. Webb, et al.

Michael J. Henke, Washington, D.C., for Union Oil Co. of Calif.

George B. Mickum, III, Washington, D.C., for Atlantic Richfield Co.

Steven A. Taube, Phillip R. Telleen, Federal Energy Regulatory Comm., Howard E. Shapiro, Sol., Washington, D.C., for Federal Energy Regulatory Comm.

John L. Williford, Bartlesville, Okl., for Phillips Petroleum Co.

J. O. Terrell Couch, Houston, Tex., for Robert Beamon, et al.

John S. Fick, Los Angeles, Cal., for Southern California Gas. Co.

Edwyn R. Sherwood, Colorado Springs, Colo., for Colorado Interstate Gas Co.

R. G. Thayer, Jr., Janice E. Kerr, San Francisco, Cal., for People of State of Cal. and Public Utilities Comm. of State of Cal.

Daniel Joseph, Jack W. Hanks, Washington, D.C., David K. Watkiss, Salt Lake City, Utah, for Northwest Pipeline Corp.

Shirley A. Woo, San Francisco, Cal., for Pacific Gas & Electric Co.

R. H. Landt, Denver, Colo., for Amoco Production Co.

Paul R. Connolly, Washington, D.C., for El Paso Natural Gas Co.

Petitions for Review of Orders of the Federal Energy Regulatory Commission.

Appeal from the United States District Court for the Western District of Texas.

Before BROWN, Chief Judge, and GODBOLD and RONEY, Circuit Judges.

ORDER:

These consolidated cases present an issue that is best handled by awaiting the action of the Federal Energy Regulatory Commission (FERC) in the related administrative proceeding raising essentially the same substantive question: Whether certain natural gas lease-sale agreements are sales of gas in interstate commerce within the meaning of § 5 of the Natural Gas Act, 15 U.S.C.A. § 717d. *See United Gas Improvement Co.* v. *Continental Oil Co. ("Rayne Field")*, 1965, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466; *Continental Oil Co.* v. *FPC ("Ship Shoal")*, 5 Cir., 1966, 370 F.2d 57, *cert. denied*, 1967, 388 U.S. 910, 87 S.Ct. 2114, 18 L.Ed.2d 1349.

Broadly stated, in the 1950's, Tenneco Oil, Sun Oil, Continental Oil, Atlantic Richfield, and several other oil companies entered into gas lease-sale agreements with El Paso Natural Gas Company in which they transferred to El Paso their working interests in certain leases in the San Juan Basin of New Mexico in return for the right to receive a so-called overriding royalty or payment. The royalty rate was to be redetermined after the initial term. If the parties could not agree on a new rate, it would be decided by arbitration.

In 1973, Sun Oil and El Paso failed to agree on a new override rate for their lease-sale agreement. A Board of Arbitrators awarded Sun Oil an override based on the wellhead price of intrastate gas instead of the regulated interstate gas rate. Other oil companies then sought to redetermine their royalty payments with El Paso.

El Paso brought four separate actions in the District Court for the District of Columbia, seeking a declaratory judgment that the royalty recipients were selling gas for resale in interstate commerce and that they had to seek certification from the Federal Power Commission (FPC) before collecting the claimed overriding royalties in excess of the regulated interstate rate.

The cases were consolidated and transferred to the Western District of Texas. On June 3, 1984, El Paso moved to refer the case to the FPC. The lower court carried the request with the case. After a lengthy trial, the District Court found that the lease-sale agreements were not economically equivalent to sales of gas in interstate commerce. The Court dismissed El Paso's complaint for lack of jurisdiction and effectively, although not explicitly, denied El Paso's motion for reference to FPC. *El Paso Natural Gas Co.* v. *Sun Oil et al.*, W.D.Tex., 1977, 426 F.Supp. 963.

El Paso appealed and on April 27, 1977, moved this Court to refer the appeal to the Commission. The motion was granted in a single judge order on August 4. This order, however, was vacated by this panel on January 8, 1978, and we heard oral argument on the merits of the case. *El Paso Natural Gas Co.* v. *Sun Oil et al.*, No. 77-1762 and the companion case (77-2613, *et seq.*).

When El Paso filed its motion for reference in the District Court on June 3, 1974, it also filed a complaint with the FPC to require the royalty interest owners in the San Juan Basin to show cause why they should not be directed to obtain certification of public convenience and necessity and to file rate schedules in accordance with those provisions. The FPC deferred action on the complaint pending the decision of the federal court in the Western District of Texas. On June 3, 1977, after the District Court's decision, the Commission issued an order instituting a show cause proceeding. The Commission denied a rehearing of its order on July 29.

In August 1977, Tenneco Oil, Atlantic Richfield, Sun Oil, and other companies filed petitions for review of the June 3 and July 29 orders of the Commission. *Tenneco Oil Co., et al.* v. *FERC*, Nos. 77-2613, *et al.* On September 12, 1977, and January 8, 1978, we denied their motions to stay the show cause proceeding. Hearings in the proceeding are now being held. The Commission has agreed, however, to bifurcate its proceeding so that a decision on the jurisdictional issue will be reached before the remedy question is decided.

Pursuant to this Court's January 8, 1978 order, we heard oral argument on the merits of appeal Nos. 77-2613, *et al.* along with appeal No. 77-1762. We now hold that the Court should have the full benefit of the opinion of the FERC (successor to the FPC) before deciding the appeal from the District Court. *J. M. Huber Corp.* v. *Denman*, 5 Cir., 1966, 367 F.2d 104; *Weymouth* v. *Colorado Interstate Gas Co.*, 5 Cir., 1966, 367 F.2d 84; *see Mississippi Power & Light Co.* v. *United Gas Pipe Line Co.*, 5 Cir., 1976, 532 F.2d 412, 418, *cert. denied*, 1977, 429 U.S. 1094, 97 S.Ct. 1109, 51 L.Ed.2d 541.

Accordingly, with respect to appeal from the District Court in No. 77-1762, the Court will withhold decision pending receipt of the opinion of the Commission in the proceedings involved in Nos. 77-2613, *et al.* We retain jurisdiction over both cases for the entry of whatever orders are necessary to assure that this matter is expeditiously considered by the FERC. If there is any indication of undue delay or the failure to act, the Court will take whatever proper action is reasonably necessary.

After the FERC reaches its decision concerning the gas lease-sale agreements and all petitions for rehearing have been considered, the Commission should file its orders, opinions, etc., with this Court for its consideration. The parties, without further leave, should then file briefs on what action this Court should take in either one or both of these proceedings now before us. The Court again admonishes counsel to avoid needless duplication.

6. ORDER OF COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC* (OCTOBER 25, 1978)

FOR THE FIFTH CIRCUIT

Nos. 77-2613, *et al.*
(No. 77-2845)

TENNECO OIL COMPANY, *ET AL.*,
(WILLIAM G. WEBB, *ET AL.*)
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

On Petitions For Review Of Orders Of The Federal Energy Regulatory Commission (Texas Cases)

No. 77-1762

EL PASO NATURAL GAS COMPANY, *ET AL.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *ET AL.*,
Defendants-Appellees.

Oct 25 '78
Edward W. Wadsworth
Clerk

Appeal From The United States District Court For The Western District Of Texas

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Before BROWN, Chief Judge, GODBOLD and RONEY, Circuit Judges

BY THE COURT:

In connection with the motion of William G. Webb for clarification, the Court states that since William G. Webb was not a party to the District Court proceedings, the order of this Court with respect to that proceeding will not have any effect as to William G. Webb as a party; however, William G. Webb is very much a party to the proceedings pending before the Federal Energy Regulatory Commission and will, along with all other parties to that proceeding, be affected and bound by the action of the Commission and, on appeal or review by this Court, by the orders of this Court.

7. JUDGMENT OF THE COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC*, NO. 80-2404 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

No. 80-2404

FERC Nos. CP74-314, CP76-327, and CI77-526

TENNECO OIL COMPANY, *ET AL.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondents.

Petitions For Review Of Orders Of The Federal Energy Regulatory Commission

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Before BROWN, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

These causes came on to be heard on the petitions of Tenneco Oil Company, et al., for review of orders of the Federal Energy Regulatory Commission, and were argued by counsel;

ON CONSIDERATION WHEREOF, It is now ordered and adjudged by this Court that the orders of the Federal Energy Regulatory Commission in these causes be, and the same are hereby, reversed;

IT IS FURTHER ORDERED that intervenors-respondents pay to petitioners, the costs on appeal to be taxed by the Clerk of this Court.

July 5, 1983

ISSUED AS MANDATE: DEC 14 1983

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-October 14, 1980.

8. JUDGMENT OF THE COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC*, NO. 77-2613 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

No. 77-2613

FERC Nos. CP74-314, et al.

TENNECO OIL COMPANY, *ET AL.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondents.

Petitions For Review Of Orders Of
The Federal Energy Regulatory Commission

Before BROWN, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

These causes came on to be heard on the petitions of Tenneco Oil Company, et al., for review of orders of the Federal Energy Regulatory Commission, and were argued by counsel;

ON CONSIDERATION WHEREOF, It is now ordered and adjudged by this Court that the orders of the Federal Energy Regulatory Commission in these causes be, and the same are hereby, dismissed;

IT IS FURTHER ORDERED that intervenors-respondents pay to petitioners, the costs on appeal to be taxed by the Clerk of this Court.

July 5, 1983

ISSUED AS MANDATE: DEC 14 1983

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-October 14, 1980.

9. JUDGMENT OF THE COURT OF APPEALS, *EL PASO NATURAL GAS CO.* V. *SUN OIL COMPANY*, NO. 77-1762 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

No. 77-1762

D.C. Docket No. MO-74-CA-57

EL PASO NATURAL GAS COMPANY, *ET AL.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *ET AL.*,
Defendants-Appellees.

Appeals From The United States District Court For The Western District Of Texas

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Before BROWN, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

IT IS FURTHER ORDERED that plaintiffs-appellants pay to defendants-appellees, the costs on appeal to be taxed by the Clerk of this Court.

July 5, 1983

ISSUED AS MANDATE: DEC 14 1983

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*Former Fifth Circuit case, Section 9(3) of Public Law 96-452-October 14, 1980.

10. ORDER OF THE COURT OF APPEALS DENYING PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC (DECEMBER 2, 1983)

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

NOS. 77-1762, 77-2613 and 80-2404

EL PASO NATURAL GAS COMPANY, *et al.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *et al.*,
Defendants-Appellees.

TENNECO OIL CO, *et al.*, *Petitioners,*

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

TENNECO OIL COMPANY, *et al.*,
Petitioners

v.

FEDERAL ENERGY REGULATORY, COMMISSION,
Respondent.

Nos. 77-1762, 77-2613 and 80-2404.

**Appeal From The United States District Court
For The Western District Of Texas**

**Petitions For Review Of Orders Of The
Federal Energy Regulatory Commission**

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-October 14, 1980.

U.S. COURT OF APPEALS
FILED
DEC 2 1983
Gilbert F. Ganucheau
Clerk

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion July 5, 5 Cir., 1983, 708 F.2d 1011).

(December 2, 1983)

Before BROWN, RONEY and TJOFLAT, Circuit Judges.

PER CURIAM:

(√) The Petitions for Rehearing Are DENIED and no member of this panel nor Judge of this Administrative Unit in regular active service having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16; Fifth Circuit Judicial Council Resolution of January 14, 1981), the suggestions for Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

Paul H. Roney
PAUL H. RONEY
United States Circuit Judge

11. ORDER OF THE FEDERAL ENERGY REGULATORY COMMISSION DENYING APPLICATIONS FOR REHEARING, *EL PASO NATURAL GAS CO.*, 13 FERC ¶ 61,239 (DECEMBER 18, 1980)

13 FERC ¶ 61,239

El Paso Natural Gas Company, Docket No. CP74-314; Northwest Pipeline Corporation, Docket No. CP76-327; Sun Oil Company, et al., Docket No. CP77-526

Order Denying Applications for Rehearing

(Issued December 18, 1980)

Before Commissioners: Georgiana Sheldon, Acting Chairman; Matthew Holden, Jr., George R. Hall and J. David Hughes.

On October 24, 1980, a number of producer-respondents[1] filed applications seeking rehearing of the Commission's order issued in the above-captioned proceeding on September 25, 1980. Upon review, the Commission finds the applications for rehearing disclose no new facts or principles of law which would warrant modification of the September 25 order. Rehearing shall therefore be denied.

On October 16, 1980, the Commission staff filed a motion concerning the remedy phase of this proceeding. In the order of September 25, the Commission ordered that a hearing be held to determine proper remedies for past and future periods in light of the Commission's determination in the September 25 order that it had jurisdiction over the lease-sale agreements at issue in this proceeding. In its October 16 motion, the staff questions whether the Commission intended the remedy phase

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[1] Tenneco Oil Company, Contintental Oil Company, American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company, Mr. and Mrs. Morris Mizel, Union Oil Company of California, Atlantic Richfield Company, Sun Oil Company (Delaware), F.H.N., Ltd., W. Watson LaForce, Jr., Robert Beamon, Individually and as Trustee, Thomas L. Hail, Trustee, Pattie Ann Beamon Lundell, William G. Webb, Phillips Petroleum Company, Getty Oil Company, Amoco Production Company, and Mobil Oil Corporation.

to begin immediately. The staff argues that the remedy-phase hearing should begin immediately and requests the Commission to so order.

Upon review of this matter, we find no need to act on the staff's motion. There is no intent whatsoever on the Commission's part to delay the remedy-phase hearing. We do not believe the order of September 25 can reasonably be interpreted as suggesting or authorizing any delay in convening the further hearing. We believe the scheduling of the hearing should be left to the discretion and judgment of the presiding judge. We think it was clearly reasonable for the judge to defer scheduling the hearing while the applications for rehearing of the September 25 order were pending.

The Commission orders:

The applications for rehearing of the order of September 25, 1980, are denied.

12. NATURAL GAS ACT, §§ 1(b), 2(6), 4(a), 7(c)

Section 1(b), 15 U.S.C. § 717(b), provides in full:

The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Section 2(6), 15 U.S.C. § 717a(6), provides in full:

(6) "Natural-gas company" means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale.

Section 4(a), 15 U.S.C. § 717c(a), provides in full:

All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

Section 7(c), 15 U.S.C. § 717f(c), provides in part:

No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations.

Office - Supreme Court, U.S.
FILED
MAY 11 1984
ALEXANDER L. STEVAS,
CLERK

Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443, 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA AND THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

EL PASO NATURAL GAS COMPANY,

PACIFIC GAS AND ELECTRIC COMPANY AND SOUTHERN CALIFORNIA GAS COMPANY

and

THE FEDERAL ENERGY REGULATORY COMMISSION,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

THE PUBLIC UTILITY COMMISSIONER OF OREGON, *et al.*

and

NORTHWEST PIPELINE CORPORATION, *et al.*,
Petitioners,

v.

PHILLIPS PETROLEUM COMPANY, *et al.*,
Respondents.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF IN OPPOSITION OF RESPONDENTS TENNECO OIL COMPANY, *ET AL.*

[Counsel Listed on Inside Cover]

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Counsel for Respondents
W. Watson LaForce, Jr., *et al.*

May 11, 1984

QUESTIONS PRESENTED

1. Whether the transfers of title to leasehold interests in the 1950's, where the underlying reserves did not meet the *Rayne Field* standard of "proven and substantially developed" so as to be "imminently capable of producing gas in commercial quantities," and the transfers were not the "economic equivalent" of sales of gas, constitute jurisdictional sales of natural gas.

2. Whether Section 2 (22) of the Natural Gas Policy Act of 1978 provides a new basis for reviewing transfers of title to leases after December, 1978, thereby rendering the decision of the Court of Appeals prospectively moot.

3. Whether the effect of this Court's decision in *Mid-Louisiana* renders the Court of Appeals decision prospectively moot.

PARENT COMPANIES, SUBSIDIARIES AND AFFILIATES OF RESPONDENT CORPORATIONS

Parent Companies, Subsidiaries (Except Wholly-Owned Subsidiaries) and Affiliates of Tenneco Oil Company:

Tenneco Corporation
Tenneco Inc.
Akulu Chemicals (PTY) Ltd.
Akulu Marchon (PTY) Ltd.
Albright & Wilson (Australia) Ltd.
Albright & Wilson Match Phosphorus Co. Ltd.
Arndale Fuels Ltd.
Bracey Petroleum Products Ltd.
Butler Oil Products Ltd.
Case Poclain GmbH & Co.
Collins Pipeline Company
Depositas Del Norte, S.A.
FC Marine Inc.
HT Gathering Company
Intertrac A.G.
Intertrac America Corporation
Intertrac G.B. Ltd.
Intertrac Italiana S.R.L.
Intertractor Viehmann GmbH & Co.
J.I. Case do Brasil & Cia.
Kern Island Water Company
Kern River Canal and Irrigating Company
Losenhausen Maschinenbau AG
Losenhausen Maschinenbau AG & Co.
Marchon-Paragon Holdings (PTY) Ltd.
Marchon-Paragon Sulphonation (Cape) (PTY) Ltd.
Marchon-Paragon Sulphonation (PTY) Ltd.
Meadows of the Kern Mutual Water Company
Mistal Inc.
Monroe Auto Pecas S.A.
Omni-Pac GmbH
P.P.M. Guindastes Hidraulicos S.A.
Poclain S.A.

Polyphosphates Inc.
S.A. Paper Chemicals (Proprietary), Limited
Sara Gretes Cafeteria AB
Skogstrea A/S
Societe Anonyme Industrielle de Resines
Stockdale Coffee Company
Stoco Mutual Water and Sewer Company
T & M Terminal Company
TENN-USS Chemicals Finance Corporation
Tees Storage Company Limited
Tenneco Oil Company of Nigeria Unlimited
Tenneco Property Corporation
Tenngasco Gas Gathering Company
Tractortechnic Canada, Ltd.
Universal Chemical Contractors (PTY)
Uplands of the Kern Mutual Water Company
Vibromax Australia (PTY) Ltd.
Vibromax France SARL
Vibromax SCI
W. R. John & Company (Rumney) Ltd.

Parent Company, Subsidiaries (Except Wholly-Owned Subsidiaries) and Affiliates of Conoco Inc.:

E.I. duPont de Nemours and Company
Cit-Con Oil Corporation
Conch International Methane Ltd. (Bahama Islands)
Conch L.N.G.
Conoco Exploration, Ltd.
Bishop Coal Company
Conrhein Coal Co. (Partnership)
Cardinal River Coals, Ltd. (Alberta, Canada)
Neptune Bulk Terminals (Canada) Ltd. (Canada)
Contochu Inc.
Harmar Coal Co.
Itmann Coal Co.
Tongue River Railroad (Partnership)
Oasis Oil Co. of Libya, Inc.

Colonial Pipeline Company
Dixie Pipeline Company
Explorer Pipeline Company
Lake Charles Pipe Line Company
Pioneer Pipe Line Company
Platte Pipe Line Company
Seadock, Inc.
Texas Offshore Port, Inc.
West Shore Pipe Line Company
Yellowstone Pipe Line Company
Kettleman North Dome Assoc.
Maritime Protection Inc.
Oil Shippers Service, Inc.
Petroleum Terminals, Inc.
Iricon Agency, Ltd.
Southern Facilities, Inc.
The Standard Shale Products Company

Parent Companies, Subsidiaries (Except Wholly-Owned Subsidiaries) and Affiliates of American Petrofina Company of Texas:

American Petrofina, Incorporated
Petrofina Delaware, Incorporated
American Petrofina Exploration Company
American Petrofina Holding Company
Petrofina, S.A. (Belgium)
Cos-Mar, Incorporated
Mid-County Chemical Company
Fina Supply Inc.
American Petrofina Marketing Inc.

Parent Company, Subsidiaries (Except Wholly-Owned Subsidiaries) and Affiliates of Delta Drilling Company:

Perforadora Central, S.A. de C.V. (Mexico)
Grupo Constructor Central, S.A. de C.V. (Mexico)
Delta Marine Drilling Company

Tripart (I) Corp.
Tripart (II) Corp.
Tripart (III) Corp.
Tripart (IV) Corp.
Tripart (V) Corp.
Tripart (VI) Corp.

Parent Company, Subsidiaries (Except Wholly-Owned Subsidiaries) and Affiliates of Sun Exploration and Production Company:

Sun Company, Inc.
Alaska Bulk Carriers, Inc.
Hemisphere Oil Company. Inc. (Puerto Rico)
Mid-Valley Pipeline Company
Suncor, Inc. (Canada)
Lugrasa, S.A. (Panama)
Nuestro Publications, Inc.
Vessey Chemicals Pty. Ltd. (Australia)
Carboline GMBH
Carboline Coatings Ltd. (New Zealand)
Carboline Southeast Asia Ltd. (Singapore)
Taranaki Blast Services Ltd. (New Zealand)
Japan Carboline Company (Japan)
Carboline Europe (France)
Carboline S.A. de D.E.C.V. (Mexico)
Lavan Petroleum Company (Lapco) (Iran)
Japan Sun Oil Company, Ltd. (Japan)
Glacier Bay Transportation Corporation
Oil Insurance Limited (Bermuda)
Becton, Dickinson and Company
Canyon Reef Carriers, Inc.
East Texas Salt Water Disposal Company
Van Salt Water Disposal Company
Deepsea Ventures, Inc.
Explorer Pipeline Company
Texoma Pipeline Company
West Texas Gulf Pipeline Company

Sun Olin Chemical Company
International Biomedical Instruments, Inc.
VLM Corporation
Nova (an Alberta Corporation) (Alberta, Canada)
Nottingham Gas Limited (Saskatchewan, Canada)
Redwater Water Disposal Company Limited (Alberta, Canada)
Sultran Ltd. (Alberta, Canada)
Sun-Canadian Pipeline Company Limited (Ontario, Canada)
Solartech Limited (Canada)
Trilliun Exploration Corporation (Canada)
Sundata Corporation
Petromech Svn. Bhd. (Malaysia)
Sunoco de Chile Ltda. (Chile)
Venezoil C.A. (Venezuela)
White River Shale Oil Corporation
Tretol Ltd. (United Kingdom)

Parent Companies, Subsidiaries (Except Wholly-Owned Subsidiaries) and Affiliates of Atlantic Richfield Company:

[Listed in the separate "Brief in Opposition of the PLA Respondents" filed in these cases]

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443, 83-1618

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

THE PUBLIC UTILITY COMMISSIONER OF OREGON, *et al.*,
Petitioners,

v.

PHILLIPS PETROLEUM COMPANY, *et al.*,
Respondents.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF IN OPPOSITION OF RESPONDENTS TENNECO OIL COMPANY, *ET AL.*

Respondents Tenneco Oil Company, *et al.*[1] respectfully suggest that this Court deny the petitions for a writ of certiorari

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[1] The Respondents joining in this Brief in Opposition are Tenneco Oil Company, Conoco Inc., American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company,

seeking review of the decision of the United States Court of Appeals for the Fifth Circuit in this case. That opinion is reported at 708 F.2d 1011.[2]

ADDITIONAL STATUTORY PROVISION INVOLVED

In addition to Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b) (1982), certain Petitioners have invoked Section 2(22) of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301(22) (1982). That provision states as follows:

> DELIVER.—The term "deliver" when used with respect to any first sale of natural gas, means the physical delivery from the seller; except that in the case of the sale of proven reserves in place to any interstate pipeline, any intrastate pipeline, any local distribution company, or any user of such natural gas, such term means the transfer of title to such reserves.

STATEMENT OF THE CASE

Respondents are corporations, individuals, partnerships, trusts and estates who are royalty owners, not producers or sellers of natural gas. These cases were brought by El Paso Natural Gas Company ("El Paso") and Northwest Pipeline Corporation ("Northwest"), which are and have been the producers and sellers of gas under the agreements here at issue, in an effort to convert the royalty owners into jurisdictional sellers of natural gas.

In the early 1950's El Paso decided to build a pipeline to tap a new gas field. It acquired what the Federal Power Commis-

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Mr. and Mrs. Morris Mizel, Sun Exploration and Production Company, Atlantic Richfield Company, F.H.N., Ltd., W. Watson LaForce, Jr., *et al.* and Robert Beamon, Individually and as Trustee, Thomas L. Hail, Trustee and Pattie Ann Beamon Lundell (the "Beamon Parties").

[2] References in this Brief in Opposition to specific pages of the Court of Appeals decision and to specific pages of the other decisions below will be to the Appendix ("App.") filed with the Petition of The People of the State of California and The Public Utilities Commission of the State of California ("California") in No. 83-1321. References to the various petitions will be in the form "California Pet. at ____."

sion[3] described as "large, undeveloped acreage" from Delhi Oil Corporation.[4] *William G. Webb*, 49 F.P.C. 17, 18 (1973). Then and thereafter hundreds of thousands of acres of gas leases in the San Juan Basin area of New Mexico were acquired by El Paso, most of the leases with either a few wells or no wells drilled thereon. Since then, some 3,200 wells have been drilled by El Paso on the subject lease sale acreage.[5]

To acquire the leases so that El Paso could be the producer as well as the pipeline, it promised to pay a royalty to the former owners of the various leases, if gas were found pursuant to the drilling program to be conducted by El Paso. El Paso paid nothing for the leases; there was no purchase price based upon reserves in place, App. 127a, unlike *Rayne Field*,[6] *Bastian Bay*,[7] and *Ship Shoal*.[8]

El Paso presented the lease sale agreements to the Commission in both rate and certificate cases commencing in 1952.[9]

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[3] The Federal Power Commission and its statutory successor, Petitioner Federal Energy Regulatory Commission, will be referred to hereinafter as the "Commission."

[4] Delhi Oil Corporation is the predecessor-in-interest of Respondents Tenneco Oil Company and Conoco Inc. under the first and largest of the lease sale agreements at issue herein, commonly referred to by the parties as "GLA-47." *See* App. 9a.

[5] *See* "Proposed Findings of Fact and Conclusions of Law of El Paso Natural Gas Company" at 4, El Paso Natural Gas Co. v. Tenneco Oil Co., *et al.*, No. 83-50539 (Dist. Ct. Harris County, Texas, 11th Jud. Dist., filed March 21, 1984).

[6] United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392 (1965) ("Rayne Field").

[7] Pan American Petroleum Corp. v. FPC, 339 F.2d 694 (10th Cir. 1964), *rev'd*, 381 U.S. 762 (1965) ("Bastian Bay").

[8] Continental Oil Co. v. FPC, 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910 (1967) ("Ship Shoal").

[9] Immediately after the closing of GLA-47, the President of El Paso explained the transaction in detail in sworn testimony before the Commission. R. 7991-8007.

Most of the agreements were never challenged by the Commission or any party. Those that were challenged were found by the Commission, in 1973, in a final order, to constitute genuine lease sales and not to constitute sales of gas under the *Rayne Field* doctrine. *Webb*, 49 F.P.C. at 26.[10]

For some twenty years El Paso operated the lease sale properties, drilled the wells, claimed all producer federal income tax benefits, paid the royalties and collected for itself a profit, or return, on the sales of gas to its customers, a profit being impermissible if the lease sales were a "sham" or *Rayne Field* transaction. As a pipeline producer, El Paso was permitted by the Commission to include the overriding royalties in the cost of service charged in the rates to its customers as costs "prudently incurred," and collected a return on investment, depreciation, and other charges that cannot be collected by the pipeline if the gas is purchased from independent producers.

The time came to increase the royalty payments, as agreed in the lease sale agreements.[11] El Paso resisted and, only nine months after succeeding before the Commission in arguing to the contrary, El Paso sued in federal court[12] to have Respondents declared sellers of gas under the Natural Gas Act, 15 U.S.C. §§ 717-717w (1982), hoping to mitigate the royalty payments. The next year El Paso raised the same issue at the Commission, which declined to proceed until after the federal

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[10] El Paso argued in *Webb* that the lease sale agreements were *not Rayne Field* transactions. R. 17426-31.

[11] The agreements contained an arbitration clause that applied if the parties could not agree upon the amount of the redetermined overriding royalty. Pursuant to that clause, a Board of Arbitration set the overriding royalty for GLA-61, the lease sale agreement between El Paso and Sun Oil Company (Delaware), predecessor of Respondent Sun Exploration and Production Company. App. 129a.

[12] Section 22 of the Natural Gas Act, 15 U.S.C. § 717u (1982), confers exclusive jurisdiction over actions to enforce any duty created by the Natural Gas Act in the District Courts of the United States.

court had rendered its decision. *See El Paso Natural Gas Co.*, 55 F.P.C. 1677 (1976).[13]

El Paso settled the amount of the overriding royalty with the royalty owners, agreeing to pay the overriding royalty regardless of whether the Commission would authorize the inclusion of the royalty payments in its rates. R. 10403. Thereafter, in a separate case at the Commission, El Paso sought authority to charge its customers rates that included the higher overriding royalty payments.

The Commission had unquestioned jurisdiction to deny the recovery of the royalty payments in El Paso's rates. Yet in 1977 the Commission authorized El Paso to include the higher royalties in its rates, finding the royalty costs to have been prudently incurred and the resulting rate settlement between El Paso and its customers to be reasonable and proper and in the public interest. *El Paso Natural Gas Co.*, 57 F.P.C. 989, 998-1001, 1007-08 (1977). The customers of El Paso, including Petitioners here, supported this Commission Order and did not seek review of this or any subsequent order approving the inclusion of the royalties in El Paso's rates.[14]

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[13] In June, 1977, less than five months after the District Court entered judgment, the Commission instituted a proceeding on the same issue decided by the District Court: federal jurisdiction over the lease sale agreements. El Paso Natural Gas Co., 58 F.P.C. 2181 (1977). Respondents argued before the Court of Appeals on review of that Commission Order that the Commission had prejudged the case and that the doctrines of *res judicata* and collateral estoppel precluded the Commission from retrying the jurisdiction issue. The Court of Appeals allowed the Commission proceedings to go forward. Tenneco Oil Co. v. FERC, 580 F.2d 722 (5th Cir. 1978) (App. 137a-141a). Contrary to the argument of Petitioners Pacific Gas & Electric Company ("PG&E") and Southern California Gas Company ("So Cal Gas"), however, the Court of Appeals specifically held below that its decision to allow the Commission to proceed was *not* a reference of the case to the Commission under the doctrine of primary jurisdiction. App. 19a.

[14] *See* El Paso Natural Gas Co., Docket No. RP79-12 (Further Extension), *et al.*, Unreported Letter Order (August 28, 1983); El

The United States District Court for the Western District of Texas held that the lease sales were not jurisdictional sales of gas under *Rayne Field. El Paso Natural Gas Co.* v. *Sun Oil Co.*, 426 F. Supp. 963 (W.D. Tex. 1977) (App 121a-136a). The District Court found that the leases were not "proven," the leases were not "substantially developed," and the lease sales were not the "economic equivalent" of a gas sales contract. App. 131a-133a. Three years later, the Commission found the lease sale agreements to be jurisdictional sales of gas, holding that they were the "economic equivalent" of sales of gas. *El Paso Natural Gas Co.*, 12 F.E.R.C. (CCH) ¶ 61,297 (1980) (App. 21a-31a).

On review of both decisions, the United States Court of Appeals for the Fifth Circuit found that the lease sales were not subject to Commission jurisdiction, applying the standards of *Rayne Field. El Paso Natural Gas Co.* v. *Sun Oil Co.*, 708 F.2d 1011 (5th Cir. 1983) (App. 1a-19a). The Court of Appeals reversed the Commission ruling, holding that the Commission misapplied the applicable law and that its decision was not supported by substantial evidence. App. 19a. The District Court's opinion was affirmed. *Id.*

For reasons that are not clear, some Petitioners take the position that the Court of Appeals determined that the leases were proven and that the lease sales were the economic equivalent of a gas sales contract. This is not correct. The District Court specifically found that the leasehold reserves were *not* proven and that the agreements were *not* the economic equivalent of sales of gas. App. 131a-133a. The Court of Appeals affirmed the District Court. App. 19a. All the Court of Appeals can be read to say is that reserves *in the San Juan Basin* "may

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Paso Natural Gas Co., 11 F.E.R.C. (CCH) ¶ 61,215 (1980); El Paso Natural Gas Co., 8 F.E.R.C. (CCH) ¶ 62,023 (1979); El Paso Natural Gas Co., Docket No. RP78-18, Unreported Letter Order (September 5, 1978); El Paso Natural Gas Co., 59 F.P.C. 1290 (1977); El Paso Natural Gas Co., 58 F.P.C. 1978 (1977).

well have been 'proven' at least within reasonable estimates," App. 15a, but only for purposes of demonstrating the inaccuracy of the application of the jurisdictional standard by the Commission. The Court of Appeals did not hold that the leasehold reserves themselves were proven. Indeed, the Court of Appeals specifically affirmed the District Court finding that "actual drilling is the only method of definitely locating recoverable gas saturations." App. 9a.[15]

Equally, the Court of Appeals did not find the lease sale transactions to be the economic equivalent of jurisdictional sales. Rather, the Court of Appeals found that the "economic" test applied by the Commission was so broad as to convert every lease transaction involving an interstate pipeline into a jurisdictional sale if it "ultimately results in successful production and disposition of gas in interstate commerce." App. 14a. The Court of Appeals properly rejected the Commission's formulation as an incorrect application of *Rayne Field*. *Id.*[16]

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[15] Overwhelming evidence supports the District Court's finding that the leasehold reserves were not "proven," whether or not reserves in the San Juan Basin generally were " 'proven' within reasonable estimates." App. 15a. Among the most compelling is a memorandum written by a vice-president of PG&E, one of the Petitioners herein, more than a month *after* the closing of GLA-47. In it, he noted that the reservoir engineering firm of DeGolyer and MacNaughton, which was retained by PG&E and So Cal Gas to make reserve estimates in the event the customers were called upon to finance El Paso's drilling program on the acreage, reported that while there appeared to be "plenty of gas in the Blanco area as a whole . . . further drilling will be necessary before the reserves can be classified as proven." R. 8728-29.

[16] Contrary to its position in this case, in *Webb*, the Commission *rejected* the argument that some of these same lease sale agreements were the economic equivalent of sales of gas. The Commission stated: "The transactions arose out of the needs of the parties rather than being almost wholly a rearrangement of payments, as in *Rayne*, to accomplish the same result as a conventional sale." 49 F.P.C. at 26.

No new principle of law was involved in the Court of Appeals decision. It was not a case of first impression, this Court having spoken. No issue of deference to some federal agency is raised here. The Court of Appeals provided judicial review to determine whether the law was correctly applied and whether there was substantial evidence to support the agency's findings. Where, as here, review involved application of the substantial evidence standard to the Commission's findings, this Court has held that the responsibility rests with the Court of Appeals. This Court intervenes only in the " 'rare instance when the standard appears to have been misapprehended or grossly misapplied.' " *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 309-310 (1974) (citation omitted).

The Commission now argues to delete the standard of "proven and substantially developed" from the *Rayne Field* test, claiming that the Court of Appeals decision creates a "gap" in the Commission's regulatory authority. FERC Pet. at 20. But the Commission applied and relied upon the "gap" of substantial development in a case just prior to this one in order to allow a pipeline to acquire leases without subjecting the lease seller to jurisdiction. *See Texas Gas Transmission Corp.*, 3 F.E.R.C. (CCH) ¶ 61,135 (1978) (discussed hereinafter at 13-14). Reliance upon this standard in one case and claiming that the standard creates a "gap" in another constitutes an administrative double standard.

At about the same time as the Court of Appeals decision below, this Court issued its decision in *Public Service Commission of New York* v. *Mid-Louisiana Gas Co.*, ___ U.S. ___, 103 S.Ct. 3024, 77 L.Ed.2d 668 (1983) ("*Mid-Louisiana*"). Commencing October 1, 1983, El Paso implemented the *Mid-Louisiana* decision by including in its rates certain prices under Title I of the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3333 (1982) ("NGPA"), for most of its pipeline production, including production from these leases. Based upon its implementation of *Mid-Louisiana*, El Paso now complains that it will have to absorb the overriding royalty payments to Respondents and incur a loss unless the Court of Appeals

decision is reversed.[17] Although El Paso complains that the impact of *Mid-Louisiana* upon its operation of these leases is a loss, El Paso's records indicate that it stands to gain billions of dollars in additional revenues based upon its implementation of that decision.[18]

As a consequence of El Paso's implementation of the *Mid-Louisiana* decision in its rate cases before the Commission, customer rates for El Paso's company-owned gas have increased and will remain at a higher level regardless of what happens to the Court of Appeals decision below. Both the Commission and El Paso concede that, for the future, the rates to El Paso's customers will remain the same, either way.[19]

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[17] On this basis, El Paso filed suit in a Texas State District Court claiming a contractual right under the lease sale agreements to reconvey the properties to the overriding royalty owners. El Paso Natural Gas Co. v. Tenneco Oil Co., *et al.*, No. 83-50539 (Dist. Ct. Harris County, Texas, 11th Jud. Dist., judgment entered Feb. 27, 1984). El Paso's attempted abandonment of these properties prompted California to contend in its Petition that the California customers would lose a supply of gas (California Pet. at 13-14), but the trial judge has entered judgment for the royalty owners, thereby preventing El Paso from alienating the leases. Significantly, El Paso's purported authority to reassign the leases was never called to the attention of the Commission in this case or in El Paso's rate cases.

[18] In this connection, El Paso claims that its exposure is great but cannot be quantified. El Paso Pet. at 11. This is strange. In evidence in *El Paso Natural Gas Co.* v. *Tenneco Oil Co., et al.*, No. 83-50539, is an exhibit (Tenneco/Conoco No. 208A) that is the official, in-house projection by El Paso. It states that El Paso stands to increase its revenues from its customers as a result of this Court's decision in the *Mid-Louisiana* case over the amount it was collecting on a cost of service basis by some $4.6 billion over the next twenty years. If, this report claims, El Paso has to continue to honor its royalty payments, it will nevertheless realize a net $3.8 billion in additional revenues out of the $4.6 billion increase in the rates that it will collect from its customers.

[19] *See* FERC Pet. at 21; El Paso Pet. at 10-11. The Commission *may* allow a rate increase pursuant to its authority to grant special

The Court of Appeals decision does not affect the Commission's authority to set El Paso's rates to its customers for gas from El Paso's own leases either for past or for future periods.[20] The Commission and those of El Paso's customers that are Petitioners herein should not be allowed to second guess their own past decision not to challenge the inclusion of these royalties in El Paso's rates, and indeed affirmatively to approve them as just and reasonable and prudently incurred.

For the future, this case does not determine whether the customers will bear these royalties. The question is whose *stockholders* (or, which individuals, partnerships, trusts and estates—also owners of these overriding royalties) enjoy the benefits of the monies attributable to these royalties: El Paso's or Respondents'.

Respondents respectfully submit that this is not a case warranting this Court's review.

REASONS WHY THE PETITIONS SHOULD BE DENIED

The basic issue decided by the Court of Appeals below was whether the lease sale agreements constitute *Rayne Field* transactions that are subject to Commission jurisdiction. The Court of Appeals properly found that they do not.

In *Rayne Field*, this Court determined that lease transactions are subject to Commission jurisdiction if the following questions all are answered in the affirmative:

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relief on the basis of increased royalty obligations. *See* FERC v. Pennzoil Producing Co., 439 U.S. 508 (1979). No such increase has been sought and, in any event, any application will be subject to judicial review. It is interesting to note that El Paso's chief company witnesses before the Texas State District Court in *El Paso Natural Gas Co.* v. *Tenneco Oil Co., et al.*, No. 83-50539, testified in December, 1983, and January, 1984, that special relief would not be granted to El Paso on the basis of these overriding royalties.

[20] El Paso's rates are regulated by the Commission under Section 4 and Section 5 of the Natural Gas Act, 15 U.S.C. §§ 717c, d (1982), and Section 601 of the NGPA, 15 U.S.C. § 3431 (1982).

1. Did the transaction involve the transfer of proven and substantially developed reserves?
2. Was the transaction the economic equivalent of a sale of gas?
3. Was the transfer to an interstate pipeline for the purpose of interstate transmission and sale?

See Rayne Field, 381 U.S. at 401; *Ship Shoal*, 370 F.2d at 62.

As to the test of "proven and substantially developed reserves," the Court of Appeals affirmed the District Court, which found that the reserves were neither proven nor substantially developed. App. 131a-133a. The Court of Appeals ruled:

> Specifically, we hold the reserves underlying the leaseholds were not substantially developed at the time the lease sales were executed because of the lack of "imminent ability to produce in commercial quantities." App. 15a (citation omitted).

As to the test of "economic equivalent of a sale of gas," the Court of Appeals affirmed the District Court, which found that the transactions were not the economic equivalent of sales of gas. App. 133a. The Court also held that the Commission's reliance upon an "economic equivalency" standard was erroneous. The Court of Appeals found that the Commission had "elevated the first prong [of the *Rayne Field* test]—economic equivalency—from a component in the *Rayne Field* test to the determinative factor on the issue." App. 12a-13a. The Court of Appeals continued:

> Carried to its logical conclusion, the Commission's economic equivalency/commercial realities approach could render any sale of lease rights to an interstate pipeline company jurisdictional merely because the transaction ultimately results in successful production and disposition of gas in interstate commerce. App. 14a.

To support their petitions filed in this Court, the Petitioners do not so much attack the underlying factual basis for the Court of Appeals decision as they rely upon an unprecedented modifi-

cation of the *Rayne Field* standard, as well as a mischaracterization of the Court of Appeals decision. The Petitioners' "Questions Presented" demonstrate these distortions.

First, some Petitioners' "Questions Presented" *ignore* the substantial development test that has been relied upon by the Commission and the courts as an essential element of the three-part jurisdictional standard.[21] The Questions do not even challenge the holding of the Court of Appeals that the lease sale reserves were not substantially developed.

Second, the "Questions Presented" erroneously assert that the Court of Appeals found the lease sale reserves to be "proven" and found the agreements to be the "economic equivalent" of sales of gas. As demonstrated, the Court of Appeals did not so find.

Contrary to the Petitioners' assertions, the Court of Appeals decision does not interfere with the Commission's authority to regulate the rates for sales of gas from these leases. For all periods prior to and after this Court's decision in *Mid-Louisiana*, the Commission has had the power to establish the rates for sales of this gas. Moreover, based upon the passage of the NGPA and the decision in *Mid-Louisiana*, Respondents respectfully submit that the Court of Appeals decision is prospectively moot.

1. The Court of Appeals Properly Applied the *Rayne Field* Standard

In *Rayne Field*, this Court ruled that "the significant and determinative economic fact" surrounding the lease sale agreement at issue was that it involved "a proven and substantially developed field" and "accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states." 381 U.S. at 401. The lease sale in *Rayne Field* involved a definable volume of gas, such that it was *gas*,

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[21] Only the Petition of the Public Utility Commissioner of Oregon in No. 83-1432 even *mentions* the substantial development test in its "Question Presented."

rather than merely the right to explore for and develop potential gas reserves, that was transferred. In *Rayne Field*, 19 out of a possible 26 wells had been drilled on the subject acreage. *Id.* at 396 n. 3. Substantial development of the leasehold acreage permitted estimates of reserves to be the basis of the purchase price for the leases. This Court stated:

> The substantiality of development is a relevant consideration, for the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce which, as Phillips held, the Act has affirmatively placed within Commission jurisdiction. *Id.* at 403.

By focusing on the substantiality of development of the leasehold reserves, this Court established a logical standard for determining equivalence to a sale of gas. If substantial development of the underlying reserves does not exist at the time of the lease transfer, a sale of gas in place is impossible because a definable volume of gas is uncertain, and estimates of reserves cannot be relied upon by the parties to the transfer.[22]

The Commission now argues to ignore the *Rayne Field* requirement that the leases transferred be "proven and substantially developed," claiming that by relying on this standard the Court of Appeals has created a "gap" in the Commission's regulatory authority. FERC Pet. at 20. Yet the Commission relied upon the "gap" of substantial development in a case just prior to this one in order to allow a pipeline to acquire leases without subjecting the lease seller to jurisdiction.

In *Texas Gas Transmission Corp.*, 3 F.E.R.C. (CCH) ¶ 61,135 (1978), the Commission concluded that because only 14 out of the 50 wells drilled on the leasehold acreage had been

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[22] In *Rayne Field*, *Bastian Bay* and *Ship Shoal*, the interstate pipelines agreed to pay a lump sum for the leases based upon an agreed upon estimate of reserves. In *Ship Shoal*, for example, the pipeline agreed to pay $97 million based upon an agreed reserve estimate. *Ship Shoal*, 370 F.2d at 60. By contrast, El Paso paid nothing to the lease owners for the leases in the San Juan Basin. A lump sum payment for reserves would have been impossible due to the minimal drilling that had occurred on the vast lease acreage.

completed, and 50 more wells were to be drilled, the subject acreage was "essentially undeveloped" at the time the leases were transferred, and the transfer did not constitute a jurisdictional sale. The Commission stated:

> Since the Loe interests had not sufficiently developed the field to be able to conduct economically feasible wellhead arrangements, Loe could not have made a conventional wellhead sale to Memphis if the parties had so desired. Only 14 wells had been completed and only 10 of these were productive, it is indicated, and the remaining wells and intended wells were in different states of disrepair. *Clearly, these are essentially undeveloped reserves requiring further development for feasible production.* It is indicated that Memphis is presently engaged in a program to drill 10 new wells and to rework 20 old wells and drilling activity is already to a depth of more than 4,000 feet, or almost double the depth of the wells acquired from Loe. *Except for the small volume of actual production, all indications are that the subject reserves are essentially undeveloped.* Memphis did not acquire a known volume of developed reserves, and the purchase price was not tied to the level of any future production of the magnitude of reserves ultimately discovered. Accordingly, in our view, the sale of reserves by Loe to Memphis does not constitute a sale for resale in interstate commerce requiring a certificate under Section 7(c) of the Natural Gas Act. 3 F.E.R.C. at 61,405-406 (emphasis added).

As in *Texas Gas*, a "known volume of developed reserves" did not exist under the lease sale acreage transferred to El Paso. Unlike *Texas Gas*, however, in which "the purchase price was not tied to the level of any future production of the magnitude of reserves ultimately discovered," *id.*, the lease sale agreements herein did not even establish a purchase price for the leases. If anything, the inability to establish a purchase price demonstrates that the leases in this case were *less* developed than in *Texas Gas*. A question of fundamental fairness arises when the Commission chooses to apply the substantial development test when it wishes to approve a lease sale, as in *Texas Gas*, and to ignore it when, as in this case, it does not like the result.

Please compare the facts in the *Texas Gas* case with those before the Court of Appeals below. The largest and first of the El Paso acquisitions, GLA-47, the Delhi lease sale, had 15 wells drilled into the Mesa Verde formation on the date of execution and 16 on the date of closing. App. 66a. Full development of the 102,000 acres conveyed, under then-existing spacing requirements, would have required in excess of another 300 wells; full development under today's spacing requirements would have necessitated more than twice that number of wells.[23] Similarly, the largest and first of the Northwest lease acquisitions had *no* wells on the 188,000 acres on the date of execution. App. 16a. On the closing date, only 75 out of a possible 590 wells, under the existing spacing requirements, or approximately 1200 wells, under today's spacing requirements, had been drilled. App. 85a n.97.

These numbers, like the numbers in *Texas Gas*, are far different from those confronting this Court in *Rayne Field* and *Bastian Bay*, or the court of appeals in *Ship Shoal*. In *Rayne Field*, 19 out of a possible 26 wells had been drilled on the lease acreage. 381 U.S. at 396 n.3. In *Bastian Bay*, 32 of a possible 39 wells had been drilled on the twelve contiguous leases conveyed. R. 14126.[24] In the *Ship Shoal* case, 17 wells had been drilled at the time of the transaction on the single lease of approximately 3,000 acres. 370 F.2d at 59-60; R. 21841. By comparison, at the time GLA-47 was signed, only 24 total wells

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[23] The Pictured Cliffs formation, the only other formation with wells drilled thereon, had 9 wells drilled both at the time of execution and at the time of closing of GLA-47. App. 66a. Under applicable spacing requirements (which are the same today as in 1952), more than 600 Pictured Cliffs wells were necessary for full development.

[24] *See also* the discussion of the *Bastian Bay* facts by the Court of Appeals in Pan American Petroleum Corp. v. FPC, 339 F.2d 694, 695 (10th Cir. 1964), *rev'd*, 381 U.S. 762 (1965).

had been drilled on over 102,000 acres, with only 20 of the 146 non-contiguous leases conveyed having even one well drilled thereon. R. 3957-4127.[25]

Please look at the map lodged with the Clerk by Respondents.[26] Each small square is one square mile. Each large square is six miles square. For perspective, maps of Rhode Island and the District of Columbia, drawn to scale, are superimposed. You will note that the leases (shaded in blue) transferred by GLA-47, the original Delhi lease sale, are not contiguous and, in fact, are scattered over an axis of about 56 miles by 26 miles. There is no way that a contention can be made that

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[25] In their discussion of the "trilogy" of jurisdictional cases, Petitioners inject a prior transaction between El Paso and Delhi as a purported example of an earlier *Rayne Field* transaction between the parties. Petitioners would have this Court believe that the "Barker Dome" transaction was the predicate for and was similar to the lease sale agreements at issue herein. As a threshold matter, that transaction never has been joined in the instant case nor has it ever been found by the Commission or any court to constitute a *Rayne Field* transaction. Moreover, the Presiding Administrative Law Judge noted in his Initial Decision below that the Barker Dome transaction "is not involved in this proceeding, and is substantially different in content from the El Paso lease-sale contracts that were executed later." App. 56a. The Barker Dome transaction involved a geographical and geological area distinct from the area of the San Juan Basin covered by the lease sale agreements at issue herein.

The Barker Dome transaction did not, as Petitioners claim, represent an attempt to avoid Commission jurisdiction. The Administrative Law Judge's Initial Decision acknowledges (App. 46a-47a n. 29) that the concern expressed over Commission jurisdiction was in connection with an earlier agreement, later rescinded, that would have made Delhi a joint owner of El Paso's pipeline extending from the Barker Dome Field area. The pipeline affiliation was terminated long before the Barker Dome lease sale took place. The Commission adopted the finding of the Administrative Law Judge. App. 24a.

[26] The map is a copy of Exhibit 40-EP-1911 (GLA-47, Mesa Verde formation as of March 1, 1952) in the District Court and Commission proceedings below, R. 9972, with overlay added.

a well drilled can produce gas from leases up to 20 miles away. Indeed, the evidence shows that up to four wells per square mile are required to produce the gas from the Mesa Verde formation,[27] so one well cannot even produce the gas from one square mile. In the Pictured Cliffs formation, above the Mesa Verde, even fewer wells had been drilled.

The Court of Appeals properly noted that a comparison of the number of wells in place at the time of the lease sales' execution and the number of wells necessary to complete production from the lease sale acreage is relevant to the substantiality of development. App. 16a-17a. The more wells that must be drilled *after* the transfer of the leases, the less the acreage transferred is imminently capable of producing gas in commercial quantities, and, as this Court stated in *Rayne Field*, "the more that must be done before the gas begins its interstate journey." 381 U.S. at 403.[28]

Petitioners erroneously assert that the drilling undertaken by El Paso *after* the execution of the lease sale agreements indicates that the reserves were imminently producible in commercial quantities. Petitioners rely upon estimates made at the time GLA-47 was executed indicating that large volumes of gas could be delivered into El Paso's pipeline within a few years after execution. FERC Pet. at 19. These estimates cited by Petitioners were predicated upon drilling and development

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[27] The Court of Appeals properly noted that in 1974, El Paso applied for and obtained permission from the New Mexico Oil Conservation Commission to increase to two the number of wells permitted to be drilled on a 320-acre unit in the Mesa Verde formation. App. 16a. The State Commission order was based in part upon testimony sponsored by El Paso that rapid depletion of the Mesa Verde formation was not possible under existing 320-acre spacing. R. 16664-16736.

[28] The Court of Appeals found that in 1976, 736 wells had been drilled on the GLA-47 acreage compared to the 24 wells that had been drilled at the time GLA-47 was executed in 1952. In 1977, 365 wells had been drilled on the acreage transferred to Northwest by Phillips Petroleum Company under PLA-5, compared to *none* at the time PLA-5 was executed in 1953. App. 15a-16a.

to be conducted by El Paso *after* it acquired the leases.[29] Indeed, the rigorous development program undertaken by El Paso after the transfer of the leases, ultimately resulting in more than 3,200 wells on the lease acreage, is a measure, more than anything, of the *absence* of development that existed on the lease sale acreage at the time the agreements were executed.

El Paso, Northwest and others argue that the jurisdictional standard must be modified to eliminate the requirement that the leases be "proven and substantially developed" in order to prevent producers and pipelines, like El Paso and Northwest, from entering into lease sales that violate the Natural Gas Act. While it may seem strange for the two pipelines to make this claim about their own transactions, it seems most unlikely that the Commission can sustain such a claim, since not only has the Commission so recently applied the test of "substantial development" in order to allow an interstate pipeline to acquire leases without subjecting the royalty owner to jurisdiction as a seller of gas, *see Texas Gas*, but the Commission has scrutinized these lease sale agreements on a constant and continuing basis since their inception in the 1950's.

If El Paso and the other petitioners were to succeed in persuading this Court to alter the jurisdictional standard retroactively, the result would be not the closing of a claimed "regulatory gap," but rather that any interstate pipeline that has ever acquired leases that were subsequently successfully developed would be in violation of the Natural Gas Act. A change in the standard would call into question all of the pipeline production now owned by interstate pipelines, having acquired leases that were not substantially developed. According to the latest summary of interstate pipelines' gas supply, almost fourteen percent of total domestic reserves is owned by

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[29] The studies cited by the Petitioners indicating the volumes of gas believed to be producible from the GLA-47 acreage in four years required the drilling, *by El Paso*, of more than 250 wells. R. 9737-9746.

interstate pipelines.[30] As the Court of Appeals pointed out, under the Commission's economic equivalency test in this case, every lease sale to an interstate pipeline would be subjected to jurisdiction under the Natural Gas Act. App. 14a.

Contrary to the position it now takes, the Commission itself has found in two separate proceedings that at the time of these very lease sales, El Paso did not offer the owners of these leases adequate incentives to explore for gas and to develop and sell any reserves which might exist, under conventional sales contracts. *See William G. Webb*, 49 F.P.C. at 23, 25: *El Paso Natural Gas Co.*, 57 F.P.C. at 998. The Commission held that acquisitions of these leases "were the only means El Paso was able to attach additional dry gas reserves because the conventional gas purchase agreements failed to provide adequate incentives to the producer." *El Paso Natural Gas Co.*, 57 F.P.C. at 998.

Some Petitioners claim that El Paso was *forced* to accept these lease sales in the 1950's because of the market power of the Respondents. California Pet. at 5; El Paso Pet. at 5. This is ridiculous. Since the early 1950's, El Paso has been the largest purchaser *and* the largest producer of gas in the San Juan Basin of New Mexico. When another pipeline company moved into the Basin and began to compete for gas leases and contracts and threatened El Paso's monopoly on the California market, El Paso bought out this competitor and further reduced competition, in violation of the antitrust laws. *See U.S. v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964).[31]

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[30] Energy Information Administration, Department of Energy, Gas Supplies of Interstate Natural Gas Pipeline Companies, 1982, at 12, Table 3 (October, 1983).

[31] After a divestiture that was ordered by this Court (*see* U.S. v. El Paso Natural Gas Co., 376 U.S. at 662; U.S. v. El Paso Natural Gas Co., 358 F. Supp. 820 (D. Colo. 1972), *aff'd*, 410 U.S. 962 (1973)), the other pipeline is now known as Northwest Pipeline Corporation, a Petitioner in this proceeding.

2. The Court of Appeals Decision Does Not Expand the "Production or Gathering" Exemption of Section 1(b) of the Natural Gas Act,

Contrary to the Petitioners' claims, the Court of Appeals decision below does not expand the "production or gathering" exemption of Section 1(b) of the Natural Gas Act. 15 U.S.C. § 717(b) (1982). Rather, the decision below recognizes that lease agreements such as these, by which undeveloped leases are transferred, precede even the production and gathering of natural gas. Because the reserves underlying the subject leases were undeveloped at the time of the lease sales, no "wholesale" of gas within the meaning of *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682 (1954), was possible.

By arguing that the "production or gathering" exemption no longer exists with respect to undeveloped leases transferred to interstate pipelines, the Commission contradicts *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949) ("*Panhandle*"), in which this Court held that the "transfer of undeveloped gas leases is an activity related to the production and gathering of natural gas and beyond the coverage of the Act . . . ." 337 U.S. at 515. Accepting the Commission's argument would also resurrect the Commission determination, *rejected* by the court of appeals in *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972), that all lease sale agreements are jurisdictional sales of gas subject to Commission jurisdiction if the gas ultimately is sold in interstate commerce for resale. 463 F.2d at 258-59, 263.

The Petitioners' arguments improperly minimize the distinction drawn by this Court between *Rayne Field* and *Panhandle*, in which this Court ruled that the transfer of undeveloped leases from an interstate pipeline to an intrastate pipeline affiliate was not within Commission jurisdiction. The Court of Appeals properly noted: "[t]he Supreme Court emphasized the difference in the degree in development in explaining why it held the transactions jurisdictional in *Rayne*

Field, but nonjurisdictional in *Panhandle*." App. 15a (citation omitted).[32]

In this case, due to the minimal amount of drilling that had been conducted on only a few of the transferred leases, most of which had no wells at all, sales of commercial quantities of gas (indeed, even production and gathering of gas) was not possible upon the transfers except in small amounts on a few of the leases.[33] The terms of the lease sale agreements reflect these conditions.[34] In *Mobil*, the court noted that a gas lease "transfers only the right to explore, develop, and market if exploration is successful . . . ." 463 F.2d at 262.[35] In this case, where all

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[32] In *Rayne Field* this Court stated: "To recognize no differences between the Panhandle transfers and those in issue here . . . would turn the case-by-case process against itself." 381 U.S. at 404.

[33] Petitioners argue that the Court of Appeals' focus on the absence of substantial development overlooks the "undisputed economic fact" that a producer will not commence development of his leasehold acreage until he has obtained a market for his gas and a gas sales contract has been secured. FERC Pet. at 17 n.15. Yet in *Texas Gas*, the Commission *relied* on the fact that insufficient development had occurred on the leasehold acreage in order "to conduct economically feasible wellhead arrangements." The Commission stated that the lessor "could not have made a conventional wellhead sale . . . if the parties had so desired." 3 F.E.R.C. at 61,405-406.

[34] The terms of the agreements imposed drilling obligations upon El Paso and provided for payment of overriding royalties based only upon the gas produced. If no gas was produced, no royalties were due. Indeed, as the District Court found, the agreements provided that if drilling by El Paso indicated that acreage would not be productive of gas in commercial quantities, El Paso promptly could turn the lease acreage back. App. 126a, 132a.

[35] The court held in *Mobil* that a royalty interest retained by the lessor is not sufficient to make him a seller of gas. The court stated: "an economic interest in the proceeds of a sale, unaccompanied by authority to determine the incidents of the sale, does not make one a seller." 463 F.2d at 262. In this case, like *Mobil*, the only economic interest retained by the lease owners under the agreements was an overriding royalty. Unlike Louisiana Land & Exploration Co. v.

drilling and development was undertaken by El Paso, what was transferred was, as in *Mobil*, the right to explore for gas, *not* gas itself.

3. The Court of Appeals Decision Neither Affects the Commission's Authority To Regulate the Rates Charged Consumers for Natural Gas Nor Jeopardizes Gas Supply, as California Contends

Petitioners claim that unless the Court of Appeals decision is overturned, the Commission will be precluded from regulating the rates for natural gas charged to consumers in several western states. FERC Pet. at 10-11. This claim ignores the regulatory framework under the Natural Gas Act, under which the gas produced and sold by El Paso, "pipeline-owned" production, was regulated even *before* the *Phillips* decision and has been regulated continuously since. The Commission *always* has had jurisdiction over the rates charged by El Paso to its customers for gas from its own leases; nothing decided by the Court of Appeals operates to change in any manner this fact.

a. Prior to *Mid-Louisiana*, the Commission permitted El Paso to include the overriding royalties in its rates, and as recently as 1977 determined that El Paso was "prudent" in acquiring the leases in order to obtain a needed gas supply in the San Juan Basin. *El Paso Natural Gas Co.*, 57 F.P.C. at 998. In fact, the Commission commended El Paso in its 1977 order for the "degree of innovation and imagination" demonstrated in entering into the original agreements and the 1974 settlement agreements. *Id.* El Paso's customers did not challenge the continuing inclusion of the overriding royalties in any El Paso rate case, to and including September 30, 1983, although they had a right and an opportunity to do so.[36]

FERC, 574 F.2d 204 (5th Cir. 1978), *cert. denied*, 439 U.S. 1127 (1979), relied upon by Petitioners, in which the lessors retained control over the identity of the purchaser of the lessee's gas, in this case all control over the incidents of any sales of gas produced from the lease sale acreage was transferred to El Paso.

[36] *See* n. 14, *supra*.

Consistent approval of El Paso's rates illustrates how hollow is the claim that "the decision of the Court of Appeals has deprived consumers in the western states, especially California," of the protection of the Natural Gas Act. California Pet. at 13. Nothing in the Court of Appeals decision requires that the California customers or any customers of El Paso pay one cent of the overriding royalties. Payment of the overriding royalties is an obligation of the corporate shareholders of El Paso, and any charge for the overriding royalties in El Paso's rates is a separate matter entrusted to the Commission through its rate making jurisdiction.

With respect to potential refunds for past periods in the event the lease sale agreements are found to be jurisdictional sales of gas, each of the petitions claims, more or less, that the Court of Appeals decision has deprived the pipelines' customers of hundreds of millions, even a billion dollars in refunds. *See, e.g.*, FERC Pet. at 21. These claims have no basis in any decision by the Commission. When the Commission issued its order determining that the lease sales were subject to Commission jurisdiction, it ordered that proceedings be commenced to determine a remedy. The Commission stated:

> The basic issues to be addressed on remand are (1) whether and if so to what extent were the payments made by [the pipelines] to the overriding royalty owners excessive and therefore unlawful; (2) what *if any* amounts should be required to be refunded . . .; and (3) what level of royalties should be approved for the future? App. 30a (emphasis added).

The remedy issue never has been tried. No determination has been made, in any forum, that payments to the overriding royalty owners were excessive or that any refunds will be paid.

It is somewhat disingenuous for Petitioners to argue now that the Court of Appeals decision in 1983 deprived El Paso's customers of the benefits of the Natural Gas Act. It is also somewhat strained for the Commission to suggest that the royalty rate is too high, since the royalties agreed upon by El Paso at arm's length in the 1974 settlement agreements were, in the Commission's own words, "just and reasonable." *El Paso Natural Gas Co.*, 58 F.P.C. 2181, 2184 (1977).

The petitions by some of the customers of El Paso, specifically PG&E and So Cal Gas, also leave a certain candor behind. While PG&E and So Cal Gas assert that the royalty rate approved by the Commission (without objection) has burdened their customers (PG&E, So Cal Gas Pet. at 14), they do not inform this Court that they have been purchasing interstate gas from *their own affiliates* in preference to El Paso's gas even though El Paso's gas has been their cheapest source of interstate gas, even with the small component for the overriding royalties. The Commission now is investigating this situation in *Pacific Gas Transmission Company*, Docket Nos. RP83-113-000, *et al.* (Order denying rehearing of order consolidating proceedings entered April 2, 1984). At issue are the "minimum bills" of the interstate pipelines, including El Paso, Transwestern Pipeline Company and affiliates of PG&E and So Cal Gas. In that consolidated docket, on March 2, 1984, El Paso itself said:

> The fact that minimum bill/minimum take provisions of interstate pipelines serving the California market have caused untenable and unnecessary costs and burdens to be borne by California consumers is beyond dispute in these proceedings. Also beyond dispute is the fact that, because of such provisions, the loss of load in the California market has been borne almost entirely by El Paso despite El Paso's being the lowest cost out-of-state supplier to that market.[37]

b. Petitioners fail to inform this Court that under its implementation of the *Mid-Louisiana* decision, El Paso stands to increase its revenues from its customers, including its California customers, for pipeline production, which includes the leases involved in this suit, by more than $4.6 billion over the next twenty years. By El Paso's own estimate, if El Paso does not convert these lease sale agreements into jurisdictional sales of gas, El Paso still will realize more than $3.8 billion out of the over $4.6 billion in additional revenues that it will collect from its customers under its implementation of *Mid-*

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[37] Pacific Gas Transmission Company, *et al.*, Docket Nos. RP83-113-000, *et al.*, "Motion by El Paso Natural Gas Company for Interim Initial Decision" at 17 (filed March 2, 1984).

Louisiana.[38] In any event, according to El Paso and the Commission, the California consumer will pay the same rate for gas after October 1, 1983, albeit a much higher rate, regardless of the outcome of the instant proceeding. El Paso Pet. at 10-11; FERC Pet. at 21.

A claim is made by California that the Court of Appeals somehow has forced El Paso to attempt to reassign the gas leases to the royalty owners in the Texas State District Court proceedings, thereby risking a loss of supply to the California customers. California Pet. at 13-14. Yet it was the corporate decision of El Paso, in order to maximize its profit potential under the *Mid-Louisiana* decision—not the decision of the Court of Appeals below—that led El Paso to attempt to reassign the leases to the royalty owners. The royalty owners undertook to defeat El Paso's attempt to reassign the leases, an effort they have in common with the California consumers. The State District Court Judge entered a judgment on February 27, 1984, holding that El Paso could not reassign the leases. As a consequence, the concern expressed by California pertaining to the potential loss of gas supply presently is moot.

4. Suggestion Of Prospective Mootness

Respondents respectfully suggest that the decision of the Court of Appeals now is prospectively moot due to: (a) the decision of this Court in *Mid-Louisiana*; and (b) the passage of the NGPA.

a. As a result of this Court's decision in *Mid-Louisiana*, any leases acquired presently or in the future by pipelines for the pipeline itself to develop and produce the gas for sale will be subject to the same regulation as gas sales from independent producer-owned leases. Thus, the decision of the Court of Appeals will have no effect on the customers of interstate pipelines, because the rate charged by the producer—be it an

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[38] *See* Tenneco/Conoco Exhibit 208A admitted into evidence in *El Paso Natural Gas Co.* v. *Tenneco Oil Co., et al.*, No. 83-50539.

independent producer or a pipeline producer—will be subject to the same regulatory constraints. Therefore, the decision of the Court of Appeals is prospectively moot from the effective date of the *Mid-Louisiana* decision.

Furthermore, the Commission asserts that the rates to El Paso's customers resulting from the implementation of the *Mid-Louisiana* decision will remain the same whether the Court of Appeals is affirmed or reversed. FERC Pet. at 21. No better demonstration of prospective mootness is possible.

b. The Commission argued below, but did not bring to this Court's attention in its petition, that the NGPA added the transfer of title to proven reserves to the definition of "first sales" to be subject to the price controls of the NGPA. This is Section 2(22) of the NGPA, 15 U.S.C. § 3301(22) (1982), which provides:

> DELIVER.—The term "deliver" when used with respect to any first sale of natural gas, means the physical delivery from the seller; except that in the case of the sale of proven reserves in place to any interstate pipeline, any intrastate pipeline, any local distribution company, or any user of such natural gas, such term means the transfer of title to such reserves.

Any lease transfers that occur after the effective date of the NGPA, December 1, 1978, are subject to review under this new Act, and the pricing provisions of any sales will be governed by the NGPA. In this circumstance, it will not matter whether the lease sale is or is not subject to the Commission's jurisdiction under the Natural Gas Act, and thus the Court of Appeals decision will have no precedential effect.[39]

5. Pending Issues Not Resolved by the Court of Appeals

Other significant issues were raised and argued below but were not reached by the Court of Appeals in the light of its

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[39] El Paso argues that the passage of this Section somehow indicates that the *Rayne Field* standards of "proven and substantially developed" and "economic equivalency" were no longer operative in 1978. El Paso Pet. at 22-23. This is gainsaid by the fact that in 1978 the Commission applied these very standards in the *Texas Gas* case.

disposition of the case. Thus, these issues are not now before this Court. The Court of Appeals summarized the points as follows:

> (1) since the district court decision preceded the Commission's decision, did it have a *res judicata* effect that bound the Commission? (2) having litigated and lost in the district court, were El Paso and Northwest collaterally estopped from claiming before the Commission that the transactions are jurisdictional? (3) was the Commission bound to treat the transactions as nonjurisdictional because of its prior rulings in connection with such transfers involving some of the same parties and the same basic facts? and (4) should the district court have referred the jurisdictional issue to the Commission under the doctrine of primary jurisdiction? Other subissues argued but not decided are: (a) whether the Commission prejudged the issues, (b) whether the petitions for review in No. 77-2613 concerning the Commission's decision to conduct a show-cause proceeding on the jurisdictional issue should be dismissed for seeking review of nonfinal interlocutory orders, and (c) whether the Commission's resolution of the jurisdictional question should be given only advisory effect in the court of appeals. App. 8a-9a.

CONCLUSION

Petitioners ask this Court to review a finding by the Court of Appeals that the Commission's order was not supported by substantial evidence or, in the alternative, Petitioners seek a retroactive change in the jurisdictional standard established by this Court in *Rayne Field*. Petitioners do not even raise the issue whether the Court of Appeals correctly affirmed the District Court, which held that the leases were not proven, not substantially developed, and that the lease sale agreements were not the economic equivalent of a gas sales contract. Equally, this Court's attention is not directed to the issues not reached by the Court below. El Paso, at least, concedes that even upon a reversal a remand would be required. El Paso Pet. at 25.

For some reason, the Commission did not call this Court's attention, as it did in the Court of Appeals below, to the fact that the NGPA provides a new statutory standard for review-

ing lease sales occurring after November, 1978. Respondents suggest that Section 2 (22) of the NGPA renders the Court of Appeals decision prospectively moot.

So also does the decision of this Court in *Mid-Louisiana* render the Court of Appeals decision prospectively moot. If, as the Commission argues, the rate for sales of gas from pipeline production is now the same as the rate for sales of gas from independent producers, the decision of the Court of Appeals has no effect on the rates charged by El Paso for production from the lease sale properties.

That leaves only a retroactive change, a change that would call into question the jurisdictional status of all leases previously transferred to interstate pipelines, which now constitute some fourteen percent of total gas supply in the United States. Since the Commission itself consistently applied the standards of "proven and substantial development" and "economic equivalency" in 1978 in order to allow a pipeline to acquire leases without subjecting the lease seller to jurisdiction (*Texas Gas*), it is difficult to sustain a claim of a new "regulatory gap." This is particularly true when the principal lease sales involved in this case took place thirty years ago, even before the *Phillips* decision.

No new principle of law is involved here. The Court of Appeals decision only involves application of the test established by this Court in *Rayne Field* to the facts of this case. The Commission, and the Petitioners allied with El Paso in its effort to be relieved of its contractual obligations, decided to allow El Paso to collect the royalties, which the Commission said were "just and reasonable," in its rates. *See El Paso Natural Gas Co.*, 58 F.P.C. at 2184. This decision by the Commission and El Paso's customers passed up this opportunity to reduce their gas costs, should Respondents prevail in this proceeding. That the agreed upon overriding royalties have been included in El Paso's past rates has no bearing on the question whether these leases transferred in the 1950's met the *Rayne Field* test.

The petitions for a writ of certiorari should be denied.

Respectfully submitted,

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Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443, 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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SUPPLEMENTAL MEMORANDUM OF RESPONDENTS TENNECO OIL COMPANY AND CONOCO INC.

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June 13, 1984

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SUPPLEMENTAL MEMORANDUM OF RESPONDENTS TENNECO OIL COMPANY AND CONOCO INC.

Respondents Tenneco Oil Company ("Tenneco Oil") and Conoco Inc. ("Conoco") respectfully respond to the Court's direction contained in the letter of the Honorable Alexander L. Stevas of May 31, 1984, calling for comment on settlement agreements "which might have a bearing upon pending petitions for writs of certiorari."

The offer of settlement filed at the Federal Energy Regulatory Commission ("Commission") by Petitioner El Paso Natural Gas Company ("El Paso"), Tenneco Oil

and Conoco would constitute a full and final settlement of all proceedings involving the lease agreements covering nearly seventy percent (70%) of the volumes of gas produced by El Paso that is involved in these petitions, if approved by the Commission and other responsible governmental agencies. *See* "Joint Supplemental Brief of Petitioner El Paso Natural Gas Company and Respondents Tenneco Oil Company and Conoco Inc.," filed May 30, 1984. Because all issues would not be resolved until there is Commission approval, which would also be subject to judicial review, Tenneco Oil and Conoco are of the view that *Havens Realty Corp. v. Coleman*, 455 U.S. 363 (1982), and *Nixon v. Fitzgerald*, 457 U.S. 731 (1982), are controlling.

Some elements of the settlement, reviewed below, are not dependent upon prior regulatory approval.

Tenneco Oil and Conoco have an option to accept reconveyance of the leases. If this option is exercised, some issues would be affected. Prospectively from the date of the exercise of the option, Tenneco Oil and Conoco would cease being royalty owners and would become producers of gas subject to the Commission's jurisdiction under the Natural Gas Act, 15 U.S.C. §§ 717-717w (1982), or otherwise subject to the pricing and other provisions of the Natural Gas Policy Act, 15 U.S.C. §§ 3301-3432 (1982). Tenneco Oil and Conoco would then supplant El Paso as owners of the leases and would assume the right to drill new wells. The exercise of this option to accept reconveyance is not contingent upon prior approval by the Commission.

Tenneco Oil and Conoco have agreed to keep the royalty rate at the current level until the Commission has had the opportunity to act on the settlement. That level of royalty has been stipulated by El Paso, Petitioner California Public Utilities Commission, and El Paso's customers, including Petitioners Pacific Gas & Electric Company and Southern California Gas Company, to be just and

reasonable and in the public interest for inclusion in El Paso's rates in the settlement of its latest general rate case. That stipulation of settlement was approved by the Commission as in the public interest and as a reasonable resolution of the issues pending in that case. *El Paso Natural Gas Co.*, 23 F.E.R.C. (CCH) ¶ 61,365 (1983).

Upon approval by the Commission and other responsible governmental agencies, Tenneco Oil and Conoco would be obligated to exercise the option to accept reconveyance of the leases and would be obligated to fulfill any other terms of the settlement agreement, which includes the payment of $50 million in refunds to El Paso's customers. Tenneco Oil and Conoco have identified approximately 1,100 gross well sites that appear to warrant development if the settlement is approved.

The settlement survives denial of the petitions for writs of certiorari. As El Paso states at page 4 of its Supplemental Memorandum, "the settlement arrangements provide a reasonable, prudent, public interest resolution of a broad spectrum of issues that must be resolved irrespective of the Court's decision on the merits of these cases."

The settlement is a compromise. Neither Tenneco Oil and Conoco on the one hand nor El Paso and its customers on the other achieve all objectives that might result from continued litigation. No settlement will appease those who insist on no compromise. It is not difficult to select elements of the compromise that are less desirable to either side than one's expectations, however unrealistic the expectations may be, and to ignore the successes of negotiation. The settlement must be viewed as a whole.

Under the Commission's regulations, a proposed settlement must be accompanied by an "offer of settlement" that explains the basis of the settlement and relates the terms to the public interest. *See* Commission Rules of Practice and Procedure, 18 C.F.R. § 385.602(c) (1983).

El Paso, Tenneco Oil and Conoco filed such an offer of settlement on May 18, 1984. Tenneco Oil and Conoco have included the offer of settlement as an appendix filed herewith under separate cover for the information of the Court. In addition, the entire settlement filed at the Commission on May 18, 1984, including all agreements, representations and warranties, has been lodged with the Clerk.

The settlement filed by Tenneco Oil, Conoco and El Paso has no bearing on whether the lease sales to El Paso in the 1950's are subject to jurisdiction under the *Rayne Field* doctrine. *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965). The Court of Appeals has unanimously decided that the lease sales to El Paso do not meet the standards set by this Court in *Rayne Field*. For the reasons set forth in the "Brief in Opposition of Respondents Tenneco Oil Company, *et al.*," the petitions for writs of certiorari should be denied.

Respectfully submitted,

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APPENDIX TO THE SUPPLEMENTAL MEMORANDUM OF RESPONDENTS TENNECO OIL COMPANY AND CONOCO INC.

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APPENDIX

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

EL PASO NATURAL GAS COMPANY	Docket No. CP74-314
SUN EXPLORATION AND PRODUCTION COMPANY, *et al.*	Docket No. CI77-526
EL PASO NATURAL GAS COMPANY	Docket No. CI83-356
TENNECO OIL COMPANY	Docket No. CI84-49
CONOCO INC.	Docket No. CI84-50

OFFER OF SETTLEMENT AND JOINT REQUEST FOR APPROVAL OF STIPULATION OF SETTLEMENT AND AGREEMENT

El Paso Natural Gas Company ("El Paso"), Tenneco Oil Company ("Tenneco Oil") and Conoco Inc. ("Conoco"), pursuant to Rule 602 of the Rules of Practice and Procedure (18 C.F.R. § 385.602) of the Federal Energy Regulatory Commission,[1] hereby jointly submit this Offer of Settlement in the above-captioned proceedings. Each respectfully requests that the Commission promptly approve the attached "Stipulation of Settlement and Agreement" ("Settlement"), together with all related Operative Agreements, as a full, fair, final and reasonable resolution of such proceedings as they affect El Paso, Tenneco Oil and Conoco, and issue all approvals and authorizations necessary for effectuation of this settlement.[2]

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[1] The Federal Energy Regulatory Commission, and its statutory predecessor, the Federal Power Commission, are collectively referred to herein as the "Commission."

[2] The Explanatory Statement requested by Rule 602 is incorporated in this Offer of Settlement. A form of Commission order approving the settlement is attached as Appendix A hereto.

INTRODUCTION

This joint Offer of Settlement will resolve all outstanding issues related to those gas lease sale agreements ("GLA's") between El Paso, Tenneco Oil and Conoco, hereinafter referred to as GLA's 47, 52, 60 and 78.

Although relating to only four of eighteen GLA's at issue in Docket No. CP74-314, *et al.*, production attributable to these four GLA's constitutes approximately 70 percent of total production on all GLA's and approximately 15 percent of El Paso's total gas supply from the San Juan Basin. Thus, settlement by these parties will resolve as to the great majority of the gas involved in Docket Nos. CP74-314, *et al.* and CI83-356 and as to Docket Nos. CI84-49 and CI84-51 in their entirety, all issues as between El Paso, Tenneco Oil and Conoco raised in highly complex litigation which has already consumed eleven years without resolution, and will secure for El Paso and its customers the benefits described herein.

Because this Settlement will resolve the overwhelming majority of the litigation in the above dockets, Applicants request its expeditious consideration and approval.

The nature of the settlement and the reasons why it should be promptly approved are described below:

I.

BACKGROUND

The subject of the controversy between El Paso and Tenneco Oil and Conoco, and the subject of the Offer of Settlement herein, are the GLA's entered into between El Paso and predecessors-in-interest of Tenneco Oil and Conoco in the early 1950's. The GLA's conveyed to El Paso the working interests held by the predecessors of Tenneco Oil and Conoco in oil and gas leases in the San Juan Basin area of New Mexico. GLA-47, the first of the GLA's involved in this proceeding, and the largest, was signed on January 18, 1952 and covered 102,400 acres.

GLA-52, signed on April 19, 1952, covered 29,600 acres. GLA-60 was signed on September 26, 1952 and covered 3,500 acres. GLA-78, signed on July 8, 1953, covered 10,500 acres. The four GLA's in which Tenneco Oil and Conoco presently have an interest are among a series of GLA's entered into between El Paso and various lease owners in the San Juan Basin in the 1950's.

The GLA's reserved to the predecessors-in-interest of Tenneco Oil and Conoco an overriding royalty on gas calculated in a number of cents per Mcf, which amount escalated over time pursuant to a schedule in each GLA. The GLA's provided for redetermination of the overriding royalty through negotiation or arbitration at specified intervals. The GLA's stated that if the overriding royalty was to be redetermined by a board of arbitration, the arbitrators were to base their decision on the then current field prices of then newly negotiated contracts for gas purchased by El Paso. The GLA's also reserved to the predecessors-in-interest of Tenneco Oil and Conoco an overriding royalty of one-third of the net liquids extracted from the gas stream, to be taken in value or in kind.

Tenneco Oil and Conoco succeeded to their interests in GLA's 47, 52, 60 and 78 in 1964 as a result of their acquisition of certain of the assets of the Delhi-Taylor Oil Corporation ("Delhi-Taylor"), which had succeeded to the rights under these GLA's. At the present time, Tenneco Oil and Conoco share an equal and undivided interest in each of the GLA's.[3]

In 1973, negotiations between Sun Oil Company ("Sun") and El Paso failed to achieve redetermination of the overriding royalty on gas under GLA-61, one of

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[3] In 1964 Tenneco Oil and Conoco also succeeded to the interests of Delhi-Taylor in other properties in the San Juan Basin and elsewhere. Included among the interests to which they succeeded are gas sales contracts entered into between Delhi-Taylor (and others) and El Paso in the San Juan Basin.

the GLA's that is similar to GLA's 47, 52, 60 and 78 and involved in the above-referenced proceedings, but not a subject of this Settlement. Sun sought arbitration of the amount of the overriding royalty in accordance with the terms of GLA-61, and a board of arbitration awarded Sun an increase in its overriding royalty from 10 cents per Mcf to 40 cents per Mcf on July 31, 1973. Demands for similar increases in overriding royalties thereafter were made by Tenneco Oil and Conoco and other overriding royalty owners pursuant to the arbitration clauses and favored nations clauses in their GLA's.

In response to these demands, El Paso initiated suit in the United States District Court for the District of Columbia on September 14, 1973, seeking: 1) an injunction against enforcement of the Sun arbitration award; 2) an injunction against further arbitrations; 3) to avoid claims under favored nations clauses in the GLA's; and 4) declaratory judgment that the GLA transactions were price regulated sales of natural gas within the meaning of Section 1(b) of the Natural Gas Act.[4] The United States District Court for the District of Columbia consolidated the individual cases and transferred them to the Western District of Texas.

On June 3, 1974, El Paso filed a complaint with the Commission in Docket No. CP74-314, one of the Dockets herein, requesting the Commission to determine that the GLA's were jurisdictional sales of gas under the Natural Gas Act. El Paso requested that the Commission seek a reference from the District Court on the issue of jurisdiction. El Paso at the same time moved the District Court to refer the case to the Commission. Neither motion was granted.

In 1974, El Paso sought Commission approval to include in its rates its potential increased overriding roy-

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[4] 15 U.S.C. § 717(b).

alty liability under the GLA's resulting from arbitration awards or other price redeterminations. On July 15, 1974, the Commission issued an order denying El Paso rate coverage for increased overriding royalties where the liability to pay was unclear, the amount to be paid was "very uncertain," and El Paso had not yet made such increased payments.[5]

Thereafter, El Paso and Tenneco Oil and Conoco, and El Paso and the other GLA owners, signed a series of Settlement Agreements, effective October 29, 1974, by which, among other things, the level of the overriding royalty on gas under the GLA's was established for the period from June 1, 1974 forward.[6] The 1974 Settlement Agreements provided for redetermination of the overriding royalty amount on June 1 of each subsequent year according to a formula set out in the Agreements.

After the execution of the 1974 Settlement Agreements, El Paso renewed its request to the Commission to be allowed to recover the overriding royalty amounts which were then paid under the 1974 Settlement Agreements.[7] On February 16, 1977, the Commission issued an order approving a settlement of several El Paso rate cases, and permitting El Paso to recover the overriding royalties paid under the 1974 Settlement. The Commission found that El Paso acted prudently both in entering into the original GLA's in the 1950's and in entering into the Settlement Agreements with Tenneco Oil and Conoco and the other GLA owners in 1974,[8] in light of El Paso's

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[5] El Paso Natural Gas Co., 52 F.P.C. 101, 103 (1974).

[6] The settlement rate agreed upon was the highest rate of general applicability prescribed or permitted by the Commission, less seven cents.

[7] *See* El Paso Natural Gas Co., Docket Nos. RP72-150, *et al.*

[8] *Id.* at 998-99. Specifically with respect to the 1974 Settlement Agreements the Commission stated: "We have determined the settlement rates to be prudent in light of the circumstances." *Id.* at 1001.

reservations in the 1974 Settlement Agreements of the right to actively pursue the pending litigation, and El Paso's agreement to flow through all refunds ultimately obtained in such litigation.[9] The Commission concluded, "the net impact of El Paso's settlement appears to be the most favorable alternative for El Paso and its customers." [10]

The jurisdiction issue was tried before the United States District Court for the Western District of Texas. In 1977, the court held that the GLA transactions are not sales of gas subject to the Natural Gas Act and dismissed the case for lack of subject matter jurisdiction.[11]

After the issuance of the District Court decision, the Commission on June 3, 1977 instituted a show-cause proceeding in Docket Nos. CP74-314, CP76-327 and CI77-526 on the issues of: 1) Natural Gas Act jurisdiction over the GLA's; and 2) the actions that should be taken by the Commission in the event jurisdiction were found to exist.[12]

The show-cause proceeding instituted by the Commission included as parties El Paso and the GLA owners, including Tenneco Oil and Conoco, and Northwest Pipeline Corporation ("Northwest") and the owners of overriding royalties under "Pacific" lease agreements ("PLA's") entered into in the 1950's with Pacific Northwest Pipeline Company, the predecessor of Northwest. The PLA's were similar in many respects to the GLA's entered into by El Paso. Northwest had intervened in the District Court litigation with respect to one PLA,

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[9] El Paso Natural Gas Co., 57 F.P.C. 989 (1977).

[10] *Id.* at 1000.

[11] El Paso Natural Gas Co. v. Sun Oil Co., 426 F. Supp. 963 (W.D. Tex. 1977).

[12] El Paso Natural Gas Co., 58 F.P.C. 2181 (1977).

PLA-13. Northwest had been granted intervention in the Commission proceeding in 1976.[13]

In an order issued on September 25, 1980,[14] the Commission affirmed an Administrative Law Judge decision in the show-cause proceeding in which the GLA's and PLA's were determined to constitute jurisdictional sales of gas.[15] In its order, the Commission called for further proceedings before a Presiding Administrative Law Judge to determine:

> (1) whether and if so to what extent were the payment made by El Paso, Northwest and PNW to the overriding royalty owners excessive and therefore unlawful, (2) what if any amount should be required to be refunded by the royalty owners to El Paso and Northwest and flowed through by them to their jurisdictional customers, and (3) what level of royalties should be approved for the future.[16]

Petitions for review of the Commission decision on jurisdiction were consolidated with the appeal by El Paso from the District Court judgment before the United States Court of Appeals for the Fifth Circuit. At the same time, "remedy" proceedings commenced herein before the Presiding Administrative Law Judge. Prepared direct testimony and proposed exhibits were filed by El

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[13] El Paso Natural Gas Co., 55 F.P.C. 1677 (1976). Tenneco Oil and Conoco and others filed petitions for review of the Commission order instituting the show-cause proceeding. These petitions were consolidated with the appeal from the District Court decision filed by El Paso in the United States Court of Appeals for the Fifth Circuit. The Court of Appeals deferred decision on the issue of Natural Gas Act jurisdiction until the Commission issued an order in Docket No. CP74-314, *et al.* Tenneco Oil Co. v. FERC, 580 F.2d 722 (5th Cir. 1978).

[14] El Paso Natural Gas Co., 12 F.E.R.C. ¶ 61,296 (1980).

[15] El Paso Natural Gas Co., 6 F.E.R.C. ¶ 63,037 (1979).

[16] 12 F.E.R.C. at 61,685.

Paso, Northwest, and the GLA owners. A hearing on the remedy phase was scheduled to begin on September 12, 1983.

On July 5, 1983, the Court of Appeals reversed the Commission order and affirmed the judgment of the District Court, holding that the GLA's and PLA's do not constitute jurisdictional sales of gas under the Natural Gas Act.[17] The Fifth Circuit denied petitions for rehearing and suggestions for rehearing *en banc* by an unpublished order dated December 2, 1983. Petitions for a writ of certiorari have been filed in the United States Supreme Court by several parties to the proceedings.[18] No action yet has been taken by the Supreme Court on these petitions.

Following the Fifth Circuit's holding of nonjurisdiction in *Sun Oil* and the decision of the Supreme Court of the United States one week earlier that pipeline produced gas is subject to "first sale" treatment under the Natural Gas Policy Act,[19] *Public Service Commission v. Mid-Louisiana Gas Co.*,[20] El Paso on August 1, 1983, served notice on the GLA interest owners that it was reassign-

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[17] El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (Former 5th Cir. 1983). As a consequence of the Fifth Circuit decision the Presiding Administrative Law Judge suspended the remedy proceedings in these Dockets.

[18] Petitions have been filed in the following cases: California, *et al.* v. Tenneco Oil Co., *et al.*, No. 83-1321; Public Utility Commissioner of Oregon, *et al.* v. Phillips Petroleum Co., *et al.*, No. 83-1432; Northwest Pipeline Corp., *et al.* v. Phillips Petroleum Co., *et al.*, No. 83-1433; El Paso Natural Gas Co. v. Tenneco Oil Co., *et al.*, 83-1442; Pacific Gas and Electric Co., *et al.* v. Tenneco Oil Co., *et al.*, No. 83-1443; FERC v. Tenneco Oil Co., *et al.*, No. 83-1618.

[19] 15 U.S.C. § 3301, *et seq.* [hereinafter cited as the "NGPA"].

[20] —— U.S. ——, 103 S. Ct. 3024 (1983) [hereinafter cited as "*Mid-La*"].

ing to them unilaterally, effective October 1, 1983, all leasehold and other interests conveyed under the GLA's.[21]

Also on August 1, 1983, El Paso instituted suit in a state district court in Harris County, Texas in which Tenneco Oil and Conoco, among other GLA owners, were named as defendants.[22] In its petition El Paso sought a declaratory judgment under the Texas Declaratory Judgments Act[23] that certain specified provisions in the GLA's entitled El Paso to reassign to Tenneco Oil and Conoco and the other GLA owners the rights El Paso held under the GLA's. Tenneco Oil and Conoco and the other GLA owners thereafter filed answers denying El Paso's claims and asserting counterclaims against El Paso.

Concurrent with the filing of its petition in Texas state court, El Paso filed a petition with the Commission in Docket No. CI83-356 in which it noted its tendered reassignment of its lease rights under the GLA's and requested the Commission to order Tenneco Oil and Conoco and the other GLA owners to apply for and obtain certificates under Section 7(c) of the Natural Gas Act for sales of gas from the GLA acreage to El Paso.[24] Tenneco

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[21] Such reassignments were based upon provisions in the GLA's that El Paso asserted permitted it to reassign any well the operation of which had become unprofitable and, in the case of certain leases, provisions in the GLA's which El Paso asserted provided for a conversion from a royalty to a working interest upon the occurrence of a specified event. Because five of the GLA's—GLA's 153, 348, 349, 350 and 351—were not subject to such asserted rights of reassignment, El Paso's tender of reassignment as to those GLA's was subject to acceptance by the GLA owners.

[22] El Paso Natural Gas Co. v. Tenneco Oil Co., *et al.*, No. 83-50539 (11th Judicial District, Harris County, Texas).

[23] Tex. Rev. Civ. Stat. Ann. art. 2524-1 (Vernon 1965 and Vernon Supp. 1982).

[24] El Paso Natural Gas Co., FERC Docket No. CI83-356, "Petition of El Paso Natural Gas Company for Issuance of Commission

Oil and Conoco and other GLA owners filed petitions for leave to intervene in Docket No. CI83-356 and protests and objections to El Paso's petition.[25]

Solely as a protective matter, in order to protect their rights in the event the Commission initiated action in conjunction with El Paso's petition in Docket No. CI83-356, Tenneco Oil and Conoco each filed conditional applications for certificates of public convenience and necessity under Section 7(c) of the Natural Gas Act covering sales of gas from the GLA properties to El Paso. These applications for conditional certificates were filed on November 2 and 3, 1983 in Docket Nos. CI84-49 and CI84-51.[26] El Paso filed motions to intervene in both of these Dockets on December 7, 1983.[27] To date, no action has been taken by the Commission either on El Paso's petition in Docket No. CI83-356[28] or on Tenneco Oil and

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Order" (filed August 1, 1983). In its petition El Paso asserted that it was not required to obtain abandonment approval under Section 7(b) of the Natural Gas Act for the transfer of production properties and facilities subject to Commission jurisdiction. El Paso claimed that the transfer merely shifted the service obligation as to dedicated gas to Tenneco Oil and Conoco and the other GLA owners. El Paso Petition at 10-11.

[25] *See* El Paso Natural Gas Co., Docket No. CI83-356, "Petition for Leave to Intervene and Protest of Undersigned Companies and Persons" (filed August 26, 1983).

[26] Tenneco Oil Co., Docket No. CI84-49, "Application of Tenneco Oil Company for Conditional Certificate of Public Convenience and Necessity" (filed November 2, 1983); Conoco Inc., Docket No. CI84-51, "Application of Conoco Inc. for Conditional Certificate of Public Convenience and Necessity" (filed November 3, 1983).

[27] Tenneco Oil Company, Docket No. CI84-49, "Motion To Intervene of El Paso Natural Gas Company" (filed December 7, 1983); Conoco Inc., Docket No. CI84-51, "Motion To Intervene of El Paso Natural Gas Company" (filed December 7, 1983).

[28] In an order accepting for filing and suspending El Paso's proposed tariff sheets in the purchased gas cost adjustment case filed by El Paso on August 31, 1983 in Docket No. TA84-1-33, the Com-

Conoco's applications in Docket Nos. CI84-49 and CI84-51.

Because of the decision of the United States Supreme Court in *Mid-La*, and as provided in the terms of the rate settlement entered into between El Paso and its customers that was approved by the Commission on May 31, 1983,[29] El Paso, on August 31, 1983, effected its implementation of *Mid-La*, *inter alia*, as to its purchased gas costs for company owned production from the GLA acreage. The Commission accepted El Paso's PGA for filing in an order dated September 30, 1983.[30]

On February 27, 1984, after a trial on the merits of El Paso's claims in Texas state court, the trial judge entered a judgment by which the relief sought by El Paso was denied. El Paso was ordered to file a notice of rescission of its attempted reassignments and was ordered to continue to perform its duties as the working interest owner under the GLA's.[31] El Paso has preserved its statutory rights with respect to an appeal.

Since the issuance of the decision in the Fifth Circuit, some of the parties to the above-referenced proceedings before the Commission have entered into settlement agreements resolving some or all of the issues involved. Specifically, a Commission order approving a Settlement Agreement between Northwest and Phillips Petroleum Company was issued on November 23, 1983.[32] In addi-

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mission ordered that acceptance of El Paso's filing was conditioned upon "the outcome of proceedings in Docket No. CI83-356 relating to GLA production." El Paso Natural Gas Co., 24 F.E.R.C. ¶ 61,390 at 61,827 (1983).

[29] El Paso Natural Gas Co., 23 F.E.R.C. ¶ 61,365 (1983).

[30] El Paso Natural Gas Co., 24 F.E.R.C. ¶ 61,390 (1983).

[31] El Paso Natural Gas Co. v. Tenneco Oil Co., No. 83-50539, Judgement entered Feb. 29, 1984 (Dist. Ct. Harris County, Texas).

[32] 25 F.E.R.C. ¶ 61,292 (1983).

tion, Northwest and Getty Oil Company filed an Offer of Settlement with the Commission on January 31, 1984. The Presiding Administrative Law Judge certified the uncontested Offer of Settlement to the Commission on February 24, 1984.[33]

Finally, El Paso and Union Oil Company of California ("Union") entered into a settlement agreement with respect to the litigation in the State District Court in Harris County, Texas by which Union accepted El Paso's tendered reassignment of the lease rights and acreage under GLA-76, GLA-348 and GLA-349. The gas sales contract between Union and El Paso, dated October 1, 1983, is the subject of a Section 7(c) certificate application in Docket No. CI84-141.[34]

II.

SUMMARY OF THE PROPOSED SETTLEMENT

A. *The Stipulation of Settlement and Agreement*

The Settlement and the Operative Agreements resolve for all purposes all issues in these dockets as to El Paso, Tenneco Oil and Conoco by "conventionalizing" the production of natural gas from the four GLA's subject to the Settlement into sales of gas in interstate commerce for resale.

Under the terms of the Settlement, El Paso will reassign to Tenneco Oil and Conoco the interests in properties conveyed by Tenneco Oil and Conoco's predecessors-in-interest under GLA's 47, 52, 60 and 78 as of the Effective Date of the Agreement as defined in the Settlement. Under Article V of the Settlement, the Effective Date is that date on which all orders necessary to implement the

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[33] 26 F.E.R.C. ¶ 63,080 (1984).

[34] *See* Union Oil Co. of California, Docket No. CI84-141, Notice of Application for Certificate of Public Convenience and Necessity" (issued December 22, 1983).

Settlement become final, no longer subject to judicial review, and are accepted by each Applicant. Tenneco Oil and Conoco also have an option to accept the lease reassignments prior to such approvals. However, exercise of the option does not obviate the need for all Commission approvals sought herein.

B. *The Tenneco Oil and Conoco Purchase Agreements and Amendments to Gas Sales Agreements*

Upon the Effective Date, Tenneco and Conoco will commence "first sales" of natural gas in interstate commerce to El Paso in accordance with the terms and provisions of the Tenneco Oil Gas Purchase Agreement (Exhibit D) and the Conoco Gas Purchase Agreement (Exhibit E). Thereby, litigation which has been pending before this Commission and various courts over the last eleven years as to whether the overriding royalties attributable to these leases are jurisdictional sales of gas will be concluded. Pursuant to this Settlement, Tenneco Oil and Conoco will become first sellers clearly subject to the Commission's pricing jurisdiction. Approval of the Settlement will lift the burdens imposed by the overriding royalties, and two producers who have incentive to develop gas reserves in the Basin will take over the operation of the properties.

Under the Settlement, Tenneco Oil and Conoco will surrender their right to an overriding royalty of $3.74 per Mcf, which is scheduled to escalate to approximately $4.00 per Mcf as of June 1, 1984, and instead will be governed by the applicable maximum lawful prices. The parties have contracted for a base price of $2.00 per MMBtu, escalated with inflation, for a period through June 30, 1986, for gas not otherwise qualifying for a higher maximum lawful price, and thereafter a base price equal to the maximum lawful price established pursuant to Section 106(a) of the NGPA.

The $2.00 base price is a compromise of a dispute as to the appropriate price to be applied to such gas. Virtually all of that gas is currently priced at a replacement/rollover rate by El Paso in its implementation of *Mid-La* pricing. However, as of November 8, 1978, the relevant determination date for independent producer pricing under the NGPA, the GLA gas here involved was being priced by El Paso as pipeline production under the Natural Gas Act, and Commission orders approving such inclusion were in effect. Thus, there are bases for contending that higher rates, including the Section 109 rate, and even higher rates, could apply.

It is not necessary for the Commission to address and decide the legal questions posed on the pricing issues. Rather, Applicants submit that the pendency of these issues argue in favor of the compromise on the matter reached by the parties. The $2.00 base price is less than the Section 109 maximum lawful price, and it reduces as of July 1, 1986 to the rollover price. Even with this approach, San Juan Basin gas remains the lowest cost source of gas on the El Paso system.

At the same time, and in connection with the compromise on the base price, El Paso negotiated for and has received market-out rights exercisable in its sole discretion. Presently, El Paso has no judicially recognized contractual right to reduce the level of the much higher overriding royalties currently payable. Further, El Paso has not been successful thus far in its undertaking unilaterally to reassign the GLA properties as a means of lifting the overriding royalty burden, a fact reaffirmed as recently as February 29, 1984 by the Texas State District Court. Market-out provisions are thus critical to El Paso in providing a dependable mechanism to assure that it will be able to adjust pricing of the GLA gas to reflect market conditions as they change from time to time. Approval of the Settlement achieves this result.

The Gas Purchase Agreements contain provisions whereby El Paso will take or pay for 60 percent of the daily stabilized producing capacity of each well for the first two years of the two agreements. Thereafter, El Paso will take 75 percent of gas well deliverability under the Tenneco Oil contract and 85 percent of gas well deliverability under the Conoco contract.[35]

Article III of the Tenneco Oil Gas Purchase Agreement and Article IV of the Conoco Gas Purchase Agreement reserve to Tenneco Oil and Conoco the right to process all gas subject to those agreements. After all regulatory approvals have been obtained, Tenneco Oil and Conoco have the right to construct at their sole cost and expense a new, efficient liquids processing plant using modern technology (referred to herein as the New Blanco Plant). Until the construction of the New Blanco Plant, Tenneco Oil and Conoco will have the right to use El Paso's processing facilities located in the San Juan Basin, (commonly referred to as the San Juan, Chaco and Blanco Plants or the El Paso Complex), in accordance with the provisions of the El Paso Complex Gas Processing Agreement (Exhibits M and N). Once the New Blanco Plant is built, Tenneco Oil and Conoco will process all gas sold to El Paso under the Agreements in that Plant.

Pursuant to Article IV of the Tenneco Oil Gas Purchase Agreement and Article III of the Conoco Gas Purchase Agreement, Tenneco Oil and Conoco each have reserved the right to withhold from sale to El Paso up to 25 percent of their respective pro-rata share of proved

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[35] Because of the way in which the take-or pay is structured in the Conoco contract, the 85 percent take-or-pay currently translates into an effective rate of 74.4 percent. Further, because of the exclusion of certain higher cost gas from the calculation in effecting such reduction, the overall effect is to reduce the economic consequences of the take-or-pay. El Paso's take-or-pay obligation under both contracts is subject to further reduction under circumstances specified therein.

recoverable gas reserves not subject to the requirements of Section 7(b) of the Natural Gas Act; and El Paso has released and waived any rights thereto granted by Section 315(b) of the NGPA if the reserved gas is sold to an affiliate. In addition, Tenneco and Conoco each have reserved the right to terminate their respective Gas Purchase Agreements with respect to any gas as to which El Paso has exercised its contract right to "market out" by lowering the "first sales" price to that determined by El Paso to be the value of the gas to El Paso and which is not subject to the abandonment requirements of Section 7(b) of the Natural Gas Act.

The gas subject to the reservation and release is limited to gas not subject to the requirements of Section 7(b) of the Natural Gas Act. Tenneco Oil and Conoco do not have any reservation or market-out release claims as to the older, lower cost gas, thereby preserving the benefit of this lower cost gas for El Paso's customers.

At the same time, however, Tenneco Oil and Conoco have the right to commit their currently undedicated acreage in the San Juan Basin under these Agreements. Thereby, El Paso has gained a preferential contracting position as to future development on any of Tenneco Oil and Conoco's undrilled acreage in the Basin.

El Paso and Conoco and El Paso and Tenneco Oil have amended those existing gas purchase contracts referenced in Appendix A of the Tenneco Amendment of Gas Purchase Contracts (Exhibit D-1) and Exhibit A of the Conoco Amendment of Gas Purchase Contracts (Exhibit E-1) to provide Tenneco Oil and Conoco the right to process all gas sold under such gas sales contracts on the same terms and conditions as provided for in the Gas Purchase Agreements, the El Paso Complex Processing Agreement and the Gas Plant Straddle and Processing Agreement.

C. *Gas Gathering and Transportation Agreements*

Pursuant to the Gas Gathering and Transportation Agreements (Exhibits F-1, F-2, G-1, G-2, H and I), El Paso will gather and transport, on behalf of Tenneco Oil and Conoco, that gas reserved by Tenneco and Conoco and that gas subject to release from the provisions of each Gas Purchase Agreement by virtue of El Paso's exercise of its "market out" right. El Paso's obligation to gather and transport such gas on behalf of Tenneco Oil and Conoco is on a best efforts basis, subject to capacity being available in El Paso's gathering and transportation facilities.

The charges for transportation (gathering) by El Paso shall be those rates in effect and reflected from time to time as the "Production Area Charges—Field Gathering" set forth in El Paso's FERC Gas Tariff, Third Revised Volume No. 2 or any superseding tariff. The rates to be charged by El Paso for all forward haul transportation for the account of Tenneco and Conoco shall be those reflected from time to time as the "Mainline Transmission Charges" set forth in El Paso's FERC Gas Tariff, Third Revised Volume No. 2, or any superseding tariff. The back haul transportation rates to be charged by El Paso shall be equal to one-half of the forward haul transportation rates, as reflected in El Paso's FERC Gas Tariff, Third Revised Volume No. 2 or any superseding tariff.

D. *El Paso Complex Gas Processing Agreement*

The El Paso Complex Gas Processing Agreement provides that El Paso will process for Tenneco Oil and Conoco all gas produced in the San Juan Basin and sold by Tenneco Oil and Conoco to El Paso, including under both the Tenneco Oil and Conoco Gas Purchase Agreements, as well as any other gas sales contract entered into between the parties on or after the Effective Date of the Settlement. The Complex Gas Processing Agreement provides

that for the first five years of such agreement, El Paso will deliver to Tenneco Oil and Conoco at the tailgate of its Complex processing facilities, 77 percent of the liquefiables recovered from processing. For a period of five years thereafter, El Paso will deliver to Tenneco Oil and Conoco not less than 72 percent of the liquefiables recovered in processing. Provision is made for redetermination each five (5) years.

E. *Lease, Plant Siting Agreement and Gas Plant Straddle and Processing Agreement*

Pursuant to the terms of the Plant Siting Agreement between El Paso, Tenneco Oil and Conoco (Exhibit K), El Paso has leased to Tenneco Oil and Conoco approximately 30 acres of land located in the vicinity of El Paso's existing Blanco processing plant and agreed to assist and cooperate with Tenneco Oil and Conoco in their construction and operation of the New Blanco Plant which will have a design throughput capacity of 500 MMcf per day. Tenneco Oil and Conoco's right to construct and operate the New Blanco Plant is expressly conditioned upon receipt and acceptance of all regulatory approvals necessary for such construction and operation, including but not limited to all authorizations by this Commission.

Pursuant to the terms of the Gas Plant Straddle and Processing Agreement (Exhibit L), Tenneco Oil and Conoco will each commit its gas for processing in the Plant. El Paso will, for a period of twenty years, deliver to the New Blanco Plant all volumes of Tenneco Oil and Conoco gas which they have committed to El Paso under the Tenneco Oil and Conoco Gas Purchase Agreements, the Amendments to Gas Purchase Agreements and from other San Juan Basin producers whose gas is being processed in the Plant, and will supply a volume of El Paso's gas equal to the difference of those volumes of

gas processed by Tenneco Oil and Conoco for their own account and the account of others and the operational capacity of the plant. El Paso's obligations are subject to the market demand situation on its system.

In consideration for the processing of El Paso gas at the New Blanco Plant, Tenneco Oil and Conoco will receive a processing fee equal to 39 percent of the recovered liquefiable hydrocarbons. In the event Tenneco Oil and Conoco process for others at a lower processing fee, El Paso has the right to the lower processing fee.

The Straddle and Processing Agreement requires El Paso to construct and operate those tap and appurtenant facilities necessary for the delivery of gas to and acceptance of gas from the New Blanco Plant, and to make such modifications as are required for it to meet its obligations under the terms of that Agreement. It further provides that Tenneco Oil and Conoco will install and operate secondary inlet compression of at least 10,000 horsepower. Tenneco Oil and Conoco may request El Paso to shut down or idle existing compressors at the Blanco site in connection with the operation of the New Blanco Plant, but Tenneco and Conoco will replace all additional amounts of compression or horsepower which it requests El Paso to shut down or idle, subject to the 10,000 horsepower floor.

F. *Transportation and Fractionation*

El Paso will provide Tenneco Oil and Conoco with transportation and fractionation services in connection with the plant products extracted in the processing of gas in the San Juan Basin. Fractionation will be provided at a rate of 4 cents per gallon, subject to escalations for increases in costs. In the event Tenneco Oil

and Conoco build liquid transportation facilities, they will provide El Paso *pro rata* access to the facilities.

G. *Refunds*

Pursuant to Article VI of the Settlement, Tenneco Oil and Conoco each shall refund to El Paso, within 30 days of issuance of final and nonappealable orders approving this Offer of Settlement, a sum of $25,000,000, for a total of $50,000,000, in settlement of all past, present and future claims arising out of or in any way related to these docketed proceedings. These refunds are to be flowed through by El Paso to its customers under the terms of prior rate settlements. The refunds are payable without regard to whether or not the Supreme Court denies certiorari.

H. *Termination*

The Settlement may be terminated at the earlier of any of the following dates: (a) by either side if final Commission approval in a form satisfactory to such party has not issued within 15 months after the date of execution, (b) by Tenneco Oil and Conoco if such final approval has not issued within 180 days following denial of certiorari in the litigation now pending before the Supreme Court, and (c) by El Paso, if such final approval has not issued within 30 days following the final reversal of the decision in *Sun Oil, supra.* In addition, if the orders are unacceptable, any of the parties have the right to terminate the Settlement Agreement.

Because the right to terminate arises in the event that the approvals are no longer subject to judicial review, expeditious consideration by this Commission is necessary to assure that approvals become final before the termination rights arise.

III.

APPROVAL OF THE SETTLEMENT IS IN THE PUBLIC INTEREST

A. *Future Purchases on Reasonable Terms.*

Under the GLA's, El Paso is presently required to pay an amount of overriding royalty—$3.74 per Mcf—greatly exceeding the revenues it receives upon sale of the GLA production pursuant to its implementation of the Supreme Court's *Mid-La* decision even without considering El Paso's other costs of production. As a consequence, development of the GLA acreage has not proceeded at the optimum level.

The Settlement Agreement eliminates this burden on development and promotes the interests of El Paso and its customers by transferring ownership and operational control of the GLA properties to Tenneco Oil and Conoco and extinguishing the overriding royalty. Tenneco Oil and Conoco will then be able to develop and produce the properties in a manner best suited to providing gas for sale to El Paso at prices advantageous to El Paso's customers.

For their part, Tenneco and Conoco have agreed to the new arrangements on the condition that they receive no less than the normal incidents of a working interest. Thus, for example, they have insisted on the right to process the reassigned reserves for the extraction of natural gas liquids. Moreover, they have insisted upon at least partial recognition of their claim to certain rates under the NGPA.

In the Gas Purchase Agreements negotiated as a part of the total settlement, El Paso has agreed to pay the maximum lawful price established under Sections 102, 103, 107, or 108 for all gas qualifying under those sections, subject to El Paso's "market out" rights. For all other gas, the settlement provides a price of $2.00 per

MMBtu (as adjusted for inflation from the date of the settlement) through the period ending June 30, 1986, and the maximum lawful price established under NGPA Section 106(a) thereafter (currently 88.5¢ per MMBtu for pre-1973 wells). In view of the substantial benefits otherwise obtainable under the settlement and the fact that the GLA production in the aggregate continues to be priced substantially below the price of most of El Paso's alternate supplies, the settlement prices constitute a fair and reasonable resolution of the outstanding pricing issues.[36]

As to this production, there can be no doubt that in the absence of the agreed-to resolution, the appropriate pricing of this gas could be subject to litigation for years. Correct application of the NGPA to GLA production is not clear, nor is the impact of the *Mid-La* decision certain. Legal arguments have been raised which, if accepted, would result in even higher prices for the indefinite future than proposed here. By comparison, not only is the $2.00 Settlement rate for only a two-year period, but thereafter, the Settlement provides that the rate is reduced to the maximum lawful price established under Section 106(a) of the NGPA.

The customers secure significant benefit from this compromise of the pricing issue. Rather than having the pricing issue open for years with the attendant uncertainty and resulting disincentives to the fullest exploitation of these reserves, and with the concomitant possi-

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[36] There is no issue concerning the Commission's statutory authority to approve the $2.00 price. Either the wells in question are subject to Section 109, in which case the price is lawful by definition, or the wells are subject to Section 104. In the latter event, if a higher rate does not otherwise apply, the Commission is authorized to increase the statutory ceiling if the new ceiling is "just and reasonable" within the meaning of the Natural Gas Act. Section 104(b)(2). In view of the benefits of the Settlement, such a finding is clearly permissible.

bility of far higher payments for the indefinite future, they are assured of the certainty of specified prices significantly below other potential prices; these prices decline still further after a two-year period. At the same time, with the uncertainty as to pricing removed, Tenneco and Conoco would be able to engage in the timely development of the reconveyed properties, securing for the customers the benefits of a long-term supply not currently subject to deregulation. When the protection of the market-out is added, it can be seen that the customers of El Paso achieve significant benefits from the pricing under the terms of the Settlement.

Further, the proposed sales and processing arrangements will lead to lower rates for El Paso's customers than would prevail in the absence of the Settlement. So long as El Paso continues to operate under the GLA's, it remains subject to a royalty obligation that imposes a substantial loss on El Paso with respect to virtually each Mcf of gas produced from these GLA's. The inevitable consequence is that El Paso simply cannot justify further development of the GLA reserves (or, indeed, of non-GLA reserves underlying the same acreage) beyond the minimum level necessary to maintain its leases and fulfill its other obligations. By comparison, application of the pricing proposed under the terms of the Settlement renders these untapped reserves available at a price to the consumer lower than that commanded by El Paso's alternate gas sources and which, under current law, is not scheduled to be deregulated as to price. The effect of this curtailed supply, not subject to price deregulation, obviously becomes more pronounced over time as older and cheaper supplies are depleted and as the scheduled January 1, 1985 deregulation of most new sources of gas becomes imminent.

Moreover, under conditions prevailing today, the deliverability of supplies attached to El Paso's system is markedly in excess of demand. This has required El Paso

to curtail production below to take-or-pay levels in most supply areas. One result of such cut backs has been that natural gas liquid production in the San Juan Basin has suffered proportionately. Since the revenues from such liquids are credited to El Paso's cost of service (currently under a "tracking" procedure approved in Docket No. RP82-33-000), El Paso's rates are adversely affected for this reason as well. Once market conditions improve, higher San Juan production will result in correspondingly higher net liquid revenue credits as higher throughput in a more efficient plant is achieved.

Under the Settlement, arrangements are thus put in place which should directly help to stabilize, and ultimately lower, El Paso's rates to its customers. Most critically, the Settlement removes the burden of the special overriding royalties now payable to Tenneco Oil and Conoco and, with them, the existing impediment to further drilling.

In addition, the Settlement contemplates the construction of a substantially more efficient natural gas liquid extraction facility.[37] By permitting optimal liquid recovery, and price certainty, the new arrangements will provide a powerful stimulus to further development of the San Juan Basin. Insofar as El Paso and its ratepayers are concerned, such newly developed production will directly displace more expensive supplies that would otherwise be purchased, and El Paso's revenues from the incremental liquid production will be available to reduce El Paso's cost of service.

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[37] The existing Blanco Plant was originally constructed in 1953 and expanded in 1956. Using the technology of its day, the facility was able to recover all butanes and heavier hydrocarbons but only approximately 25 percent of the propane and virtually none of the ethane in the processed gas. In contrast, the New Blanco Plant will use a modern cryogenic process to recover approximately 80 percent of the ethane and essentially all heavier hydrocarbons.

Projections concerning the economic impact of these changes beyond the near term future are difficult because of their sensitivity to assumptions regarding future prices. On a conservative basis, however, El Paso estimates that while the initial impact of the Settlement will be an increase over the rates currently being charged, this increase is offset within a relatively short time, and El Paso's cost of service will then be lower (on an annual basis) than it would be in the absence of the Settlement. If more favorable but still reasonable assumptions are made regarding future natural gas liquid prices, the initial rate increases are reduced and the overall cost savings are increased.

However, current rate levels are only one of the numerous benchmarks against which the benefits of the settlement must be measured. Difficult issues with respect to the application of the NGPA and the *Mid-La* decision to GLA pricing are open and unresolved. They may remain unresolved for an extended time, and when resolved, higher rates then these resulting from the Settlement may result. By removing the source of this difficulty--pricing of GLA production, the Commission will help ensure that no such rate increase will be needed to respond to NGPA and *Mid-La* issues relating to the GLA production.

B. *Enhanced Gas Supply*

As discussed above, under the current level of special overriding royalty, El Paso simply cannot justify development of the GLA acreage beyond the levels required to meet El Paso's obligations. Since every dollar spent on such development is accompanied by a fully predictable loss on the investment, El Paso does not have the motivation to maximize development of the GLA properties.

Contrasted with this circumstance is the fact that El Paso projects the present deliverability surplus on El Paso's system to be absorbed by the market within a few

years. Further development of the GLA acreage (through early completion of the in-fill drilling program and otherwise) is therefore not only wise but absolutely necessary to avoid potentially damaging supply shortfalls. Certainly, it makes no sense to tolerate unnecessary road blocks to such development. Since prompt approval of the settlement will permit timely development of a substantial portion of such reserves, it clearly serves the public interest in this respect as well.

Further, under the Settlement and related gas purchase agreements, El Paso has the opportunity to realize significant reserve additions wholly separate from the GLA acreage. Tenneco Oil and Conoco have the option to add all of their currently undedicated acreage to their respective Gas Purchase Agreements. This gives El Paso clearly the best opportunity to secure these reserves in preference to other purchasers. Inasmuch as these reserves would likely be added at lower cost than reserves in other producing areas, the consumer again benefits. In light of these circumstances, the reservation of the 25 percent interest in the higher cost gas was a reasonable agreement in order to get access to these additional reserves.

The Settlement provides for a refund by Tenneco Oil and Conoco of $25,000,000 each, for a total of $50,000,000, in discharge of all claims arising under the GLA's. This is an appropriate resolution of the refund issue. The refund is not contingent upon whether the Supreme Court denies certiorari in the current pending cases; rather, the only condition to payment of the refund is the acceptance of this Settlement through final order no longer subject to judicial review.

Whether the customers would otherwise realize any refunds in the absence of this Settlement is problematical. Under the Fifth Circuit's decision, Tenneco Oil and Conoco owe no refunds, a result which also obtains if the

Supreme Court either denies certiorari or affirms the Fifth Circuit's decision. Even a reversal of that court's decision could result in further proceedings before the Fifth Circuit; if remedy proceedings were ultimately held before the Commission and reviewed by the courts, it could nevertheless be years before any refunds became payable. Further, arguments have been raised by Tenneco Oil and Conoco whereby they claim their refund liability has not yet begun to accrue even if the GLA's are found jurisdictional. In contrast the benefit of a present refund, currently payable, as opposed to the future contingency of an uncertain refund obligation, serves the public interest, particularly when unconditionally tied to approval of this Settlement.

The Settlement herein proposed is the product of difficult negotiations over a period of several months. By securing a substantial refund commitment notwithstanding the GLA's owners success in the courts, by placing future relations with the two principal GLA owners in a posture that achieves a stable long term supply on reasonable terms, and by doing so under arrangements which will reduce El Paso's rates below the level that would otherwise prevail, the Settlement achieves a fair balance in view of all the surrounding circumstances. This proposed resolution is accordingly fair, responsible and in the public interest and should be approved.

IV.

SPECIFIC AUTHORIZATIONS REQUESTED

El Paso, Tenneco Oil and Conoco respectfully request that the Commission's order approving the Settlement find it and all Operative Agreements described in Article V thereof, to be reasonable, prudent and in the public interest. El Paso, Tenneco and Conoco further request that such order specifically grant the following approvals and authorizations:

A. *Transfer of Leaseholds and Appurtenant Property*

Pursuant to Article V of the Settlement, El Paso will reconvey on the Effective Date of the Settlement to Tenneco and Conoco those interests in the leases and certain assets situated thereon associated with their reserved overriding royalty interests under GLA's 47, 52, 60 and 78. Until the Effective Date, gas produced from those properties will continue to flow to El Paso in interstate commerce. After the Effective Date, Tenneco and Conoco will commence "first sales" of the natural gas in interstate commerce to El Paso in accordance with the terms and provisions of the Tenneco Oil and Conoco Gas Purchase Agreements. Thus, under the structuring of the Settlement, there will be no cessation of the flow of gas to El Paso for resale in interstate commerce. The gas being sold to El Paso in the resulting sale by Tenneco and Conoco will be subject to the Commission's jurisdiction under Section 7(c) of the Natural Gas Act, except to the extent exempted from the requirements of that Act under Section 601 of the NGPA. Accordingly, El Paso applies for any necessary authorizations required under this Natural Gas Act to effect the transfer of the interests in the leases and related assets to effect the transactions contemplated by the Settlement, including, if required, any abandonment authorizations under Section 7(b) of the Natural Gas Act.

B. *Gas Purchase Agreements and Amendments to Existing Gas Sales Contracts*

Article VIII of the Tenneco Oil Gas Purchase Agreement and Article X of the Conoco Gas Purchase Agreement provide for the payment by El Paso of a base price of $2.00 per MMBtu from May, 1984 through June, 1986, escalating pursuant to Section 101 of the NGPA, for gas not otherwise qualifying for a higher maximum lawful price. Thereafter (1) all gas produced from wells drilled prior to January 1, 1973 will be priced pursuant to the provisions of Section 106(a) of the NGPA; (2) all

gas produced from wells drilled on and after January 1, 1973 and prior to January 1, 1975 will be priced pursuant to the provisions of Section 104 of the NGPA; and (3) all gas produced from wells drilled on or after January 1, 1975 will be priced in accordance with the applicable provisions of the NGPA as though such gas [had] been produced and sold by an independent producer as of November 8, 1978.

Tenneco Oil and Conoco have reserved the right in their respective Gas Purchase Agreements to process gas initially in El Paso's processing facilities located in the San Juan Basin (Commonly referred to as the San Juan, Chaco and Blanco Plants or the Complex) in accordance with the provisions of the El Paso Complex Processing Agreements. Additionally, Tenneco Oil and Conoco are obligated to process such gas in the new processing plant (the New Blanco Plant) following construction of such by Tenneco Oil and Conoco pursuant to the provisions of the Plant Siting Agreement and the Gas Plant Straddle and Processing Agreement. Finally, Tenneco Oil and Conoco may process such gas in some other plant to be located at a mutually agreed upon point in the El Paso San Juan system if for some reason the New Blanco Plant is not constructed. El Paso and Conoco and El Paso and Tenneco Oil have amended those existing gas purchase contracts referenced in Appendix A of the Tenneco Oil Amendatory Agreement (Exhibit D) and Appendix A of the Conoco Amendment of Gas Purchase Contracts (Exhibit E) to provide Tenneco Oil and Conoco the right to process all gas sold under such gas Purchase contracts on the same terms and conditions as provided for in the Gas Purchase Agreements, the El Paso Complex Gas Processing Agreement and the Gas Plant Straddle and Processing Agreement.

El Paso proposes to credit to its jurisdictional cost of service the net liquid revenues received (1) from the processing by it in the Complex of gas tendered for proc-

essing therein; (2) from the processing in the New Blanco Plant of all El Paso gas tendered for processing therein, and (3) revenues from fees charged under the Transportation and Fractionation Agreement.

Tenneco Oil and Conoco request that the Commission (a) issue certificates of public convenience and necessity authorizing the sale of gas by Tenneco and Conoco to El Paso pursuant to the terms of the Gas Purchase Agreements for that gas which remains subject to the certificate authority of the Commission under Section 7(c) of the Natural Gas Act and Section 601 of the NGPA; (b) find all rates and charges specified in the Tenneco and Conoco Gas Purchase Agreements to be "just and reasonable" under the standards of the Natural Gas Act and the NGPA; (c) approve, to the extent necessary, the reservation of processing rights in the Tenneco Oil and Conoco Gas Purchase Agreements pursuant to provisions of the Natural Gas Act, particularly Section 7(b) thereof, and any applicable provisions of the NGPA; (d) amend all certificates of public convenience and necessity, and related rate schedules, previously issued for the gas sales contracts referenced in Appendix A to the Tenneco Oil Amendatory Agreement and Exhibit A to the Conoco Amendment to Gas Purchase Contracts in accordance with the provisions of Sections 7(b) and (c) of the Natural Gas Act; and (e) approve, to the extent necessary, the amendments reserving processing rights in all other gas sales contracts referenced in Appendix A to both the Tenneco Oil Amendatory Agreement and Exhibit A to the Conoco Amendment to Gas Sales Contracts pursuant to the provisions of the Natural Gas Act and the NGPA.

El Paso requests that the Commission (a) find that the payment of all prices by El Paso under the Gas Purchase Agreements to be both prudent and just and reasonable under the standards of the Natural Gas Act and the NGPA and that El Paso will be permitted to recover in its rates and charges all prices paid to Tenneco Oil and

Conoco under the Gas Purchase Agreements pursuant to Section 601(c)(2) of the NGPA; and (b) find El Paso's proposed credit to its jurisdictional cost of service of all net liquid reserves from the processing of gas pursuant to the El Paso Complex Processing Agreement and pursuant to the provisions of the Gas Plant Straddle and Processing Agreement to be reasonable and appropriate.

C. *Transportation*

Tenneco Oil and Conoco each have reserved the right to withdraw from sale to El Paso up to 25 percent of their respective pro-rata share of proved recoverable gas reserves not subject to the requirements of Section 7(b) of the Natural Gas Act. Additionally, Tenneco Oil and Conoco each have reserved the right to terminate their respective Gas Purchase Agreements with respect to any gas which El Paso has exercised its contract right to "market out" by lowering the "first sales" price to that determined by El Paso to be the value of the gas to El Paso. This right of Tenneco Oil and Conoco to terminate is expressly limited to gas not subject to the requirements of Section 7(b) of the Natural Gas Act. El Paso has released and waived any rights granted by Section 315(b) of the NGPA as to such gas.

Pursuant to the Gas Gathering and Transportation Agreements (Exhibits F-1, F-2, G-1, G-2, H and I to the Settlement Agreement), El Paso is obligated to provide transportation services, on behalf of Tenneco Oil and Conoco, for that gas reserved by Tenneco Oil and Conoco and that gas subject to release from the provisions of each Gas Purchase Agreement by virtue of El Paso's exercise of its "market out" right. El Paso's obligation to transport such gas on behalf of Tenneco Oil and Conoco is subject to capacity being available in El Paso's gathering and transportation facilities and receipt of all necessary regulatory approvals.

The charges for transportation and gathering by El Paso shall be those rates in effect and reflected in El

Paso's FERC Gas Tariff, Third Revised Volume No. 2 or any superseding tariff.

El Paso requests that the Commission authorize and certificate the above-referenced transportation services pursuant to the provisions of Section 7(c) of the Natural Gas Act. In addition, El Paso requests that to facilitate regulatory administration, the Commission provide that a list of the receipt points added to and deleted from the Gas Gathering Agreements be filed by El Paso within ninety (90) days of the end of each calendar year.

D. *The New Blanco Plant*

In connection with the construction and operation of the New Blanco Plant, El Paso is required, pursuant to Article II of the Gas Plant Straddle and Processing Agreement, to construct and operate those tap and appurtenant facilities necessary to deliver to and accept gas from such Plant and to make any modifications required to meet its obligations thereunder. Additionally, Tenneco Oil and Conoco are required, pursuant to Article II of the Gas Plant Processing and Straddle Agreement, to install and operate at least 10,000 horsepower of secondary compression necessary for operation of the Plant, and El Paso is required, pursuant to Articles II and V of the Gas Plant Processing and Straddle Agreement, to idle or shut down reciprocating compressors located in El Paso's existing Blanco Plant. Finally, upon commencement of operations at the New Blanco Plant, El Paso is obligated to suspend certain operations at its existing Blanco Plant.

El Paso requests that the Commission (a) issue certificates of public convenience and necessity authorizing construction and operation of all tap and appurtenant facilities necessary to permit delivery of gas to and receipt of gas from the New Blanco Plant or, alternatively, find that such facilities can be constructed under its "blanket-type" certificate to the extent the require-

ments of 18 CFR § 157.208 are satisfied; (b) modify the existing certificates of El Paso to permit El Paso to modify facilities required to make connections and deliveries to and from the New Blanco Plant in accordance with the obligations of El Paso under the Gas Plant Straddle and Processing Agreement; and (c) approve, to the extent required under Section 7(b) of the Natural Gas Act, the idling or shut down of the reciprocating compressors at the existing Blanco Plant. The suspension of operations at the existing Blanco Plant described above does not raise any Section 7(b) issues inasmuch as such plant has not been certificated and is not jurisdictional under the Natural Gas Act. Should the Commission conclude otherwise, then El Paso requests approval to the extent required under Section 7(b) of the Natural Gas Act to effect suspension of such operations at the existing Blanco Plant.

E. *Accounting Entries*

As reflected in the attached schedule, upon commencement of operations of the New Blanco Plant, El Paso proposes to adjust its records to reflect the cessation of certain operations at the existing Blanco plant by El Paso as previously described. Additionally, upon reconveyance of the leases to Tenneco Oil and Conoco, El Paso proposes to adjust amounts from its book and accounts to reflect the transfer to Tenneco Oil and Conoco of El Paso's interest in the assigned properties and all related equipment required for the production and delivery to El Paso of the gas subject to reconveyance. Accordingly, El Paso respectfully requests that the Commission approve these accounting entries, subject to audit in El Paso's next general rate increase filing pursuant to Section 4 of the Natural Gas Act.

F. *Refunds*

Pursuant to Article VI of the Stipulation, Tenneco Oil and Conoco each shall refund to El Paso, within 30

days of issuance of final and nonappealable orders approving this Offer of Settlement, a sum of $25,000,000, for a total of $50,000,000, in settlement of all past, present and future claims against Tenneco Oil and Conoco arising out of or in any way connected with the issues raised in these docketed proceedings. El Paso, Tenneco Oil and Conoco respectfully request that the Commission find that payment of such refunds to El Paso, and the flow-through of such refunds by El Paso to its jurisdictional customers under the terms of its prior rate settlement agreements, represents a full and complete settlement in liquidation of any and all amounts of refunds by El Paso, Tenneco Oil and Conoco, or any of them, in these, or any future, proceedings arising out of the issues resolved by this Settlement and the Operative Agreements.

G. *Other*

Applicants respectfully request any other approvals or findings as may be necessary under the Natural Gas Act and NGPA to effectuate this Offer of Settlement (including the Settlement and Operative Agreements) and a waiver of any applicable Commission regulations under both the Natural Gas Act and NGPA as may be necessary for issuance of such approvals and findings.

Applicants request that the Commission direct the Solicitor to request the Solicitor General of the United States to file a suggestion of mootness as to Tenneco Oil and Conoco in those cases currently pending before the United States Supreme Court in Nos. 83-1321, -1432, -1433, -1442, -1443 and -1618 at such time as the Commission's order approving the Settlement becomes final and no longer subject to judicial review.

V.

ADDITIONAL REPRESENTATIONS

El Paso, Tenneco Oil and Conoco represent and stipulate that this Offer of Settlement, together with the doc-

uments attached hereto, constitutes the complete agreement among them and that there are no agreements, undertakings or conditions, express or implied, related to the settlement of this proceeding other than those described hereinabove or set forth in the attached Settlement and the related agreements and documents annexed thereto and expressly incorporated therein.

VI.

RESERVATIONS

This Offer of Settlement, which for all purposes shall include the attached Settlement and the Operative Agreements attached thereto, is submitted pursuant to Rule 602 of the Commission's Rules of Practice and Procedure. Unless the attached Settlement shall have become effective in accordance with its terms, this Offer of Settlement shall be privileged and neither its contents nor the contents of any written or oral statements made or prepared in connection with its preparation or negotiation may be used in this or any other pending or future proceeding before this or any other Commission, agency or court.

This Offer of Settlement represents a negotiated settlement with respect to the various matters agreed to herein and is intended to relate only to the specific matters referred to herein. Should this Offer of Settlement be approved, neither El Paso, Tenneco Oil, Conoco, nor any other party or the Commission and its Staff shall be deemed to have approved, accepted, agreed to or consented to any concept, method, theory, principle or statutory interpretation underlying or supposed to underlie any of the matters agreed to herein.

Should this Offer of Settlement not be approved, then all rights, claims and obligations, both procedural and substantive, of El Paso, Tenneco Oil, Conoco, any other party and the Commission and its Staff, as they existed

immediately prior to the submission of this Offer of Settlement, shall be preserved. By consenting to this Offer of Settlement, no party waives any right, claim or objection which it may otherwise have in connection with any matter not expressly provided for herein.

In the event of any inconsistency between this Offer of Settlement (excluding its attachments), on the one hand, and the attached Settlement (including the agreements and documents incorporated therein), on the other, the provisions of the Settlement and the Operative Agreements shall govern.

VII.

DISMISSAL OF TENNECO AND CONOCO AS RESPONDENTS AND TERMINATION OF PROCEEDINGS

Upon the effectiveness of the attached Settlement, Tenneco Oil and Conoco shall be deemed to be dismissed as respondents in *El Paso Natural Gas Company*, et al., Docket No. CP74-314, *et al.*, and *El Paso Natural Gas Company*, Docket No. CI83-356, and the proceedings at *Tenneco Oil Co.*, Docket No. CI84-49, and *CONOCO, Inc.*, Docket No. CI84-50, shall be deemed terminated.

CONCLUSION

El Paso, Tenneco Oil and Conoco respectfully request that the Commission accept this Offer of Settlement as full, fair and final resolution in the public interest of the captioned proceedings as to Tenneco Oil and Conoco and that it promptly issue the attached order approving the Stipulation of Settlement and Agreement without condition or modification.

Respectfully submitted,

EL PASO NATURAL GAS COMPANY

By /s/ Charles R. Jack
CHARLES R. JACK

TENNECO OIL COMPANY and
CONOCO INC.

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Conoco Inc.

DATED: May 9th, 1984

CERTIFICATE OF SERVICE

I hereby certify that I have this day caused a copy of the attached "Offer of Settlement and Joint Request for Approval of Stipulation of Settlement and Agreement" to be served upon each person on the official restricted service list compiled by the Secretary in this proceeding in accordance with the requirements of Section 2010 of the Commission's Rules of Practice and Procedure.

Dated at El Paso, Texas, this 18th day of May, 1984.

/s/ Arthur R. Formanek
ARTHUR R. FORMANEK

Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443 and 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

Supreme Court, U.S.
FILED
MAY 11 1984
ALEXANDER L. STEVAS
CLERK

NORTHWEST PIPELINE CORPORATION, *et al.*,
Petitioners,

v.

PHILLIPS PETROLEUM COMPANY, *et al.*,
Respondents.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF IN OPPOSITION OF THE PLA RESPONDENTS

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May 11, 1984

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

Whether, under section 1(b) of the Natural Gas Act, there is a "sale in interstate commerce of natural gas for resale" when leases covering potential gas-bearing lands are transferred to an interstate natural gas pipeline for the purpose of the pipeline's exploration, development and operation of the properties and

(i) no cash consideration is paid at the time of transfer for any natural gas underlying such leases, on the basis of agreed-upon reserve estimates or otherwise, and

(ii) the lease acreage is not substantially developed by drilling.

LIST OF CORPORATE PARENTS, SUBSIDIARIES AND AFFILIATES

AMOCO PRODUCTION COMPANY

Amoco Production Company is a wholly owned subsidiary of Standard Oil Company (Indiana).

The subsidiaries and affiliates (not wholly owned by Standard Oil Company (Indiana) or a wholly owned subsidiary) of Amoco Production Company are:

Amoco Australia Limited
Amoco Canada Petroleum Company, Ltd.
Amoco Credit Corporation
Amoco Oil Holdings S.A.
Amoco (U.K.) Exploration Company
Analog Devices Inc.
Cetus Corporation
Cyprus Mines Corporation

ATLANTIC RICHFIELD COMPANY

The subsidiaries and affiliates of Atlantic Richfield Company are:

Alpart Farms (Jamaica) Ltd.
Alumina Contractors Limited
Alumina Partners of Jamaica
Alyeska Pipeline Service Company
The Ambler Mining Company
Anaconda Exploration New Zealand Limited
Anaconda Holdings Do Brasil LTDA
Anaflex S.A. de C.V.
Anamax Mining Company
ARCO Australia Coal Pty. Ltd.
ARCO Solar Nigeria Ltd.
Arilan, S.A. de C.V.
Arpet Petroleum Limited
A/S Skaland Grafitiverk
Atlantic Richfield de Mexico, S.A. de C.V.

Aughinish Alumina Limited
Aughinish Estates Limited
Aughinish Finance Limited
Aughinish Property (Nominees) Limited
Badger Pipeline Company
Bingham Development Company
Black Lake Pipe Line Company
Blair Athol Coal Pty., Limited
The British American Metals Company, Limited
Candel International Limited
Caribou-Chaleur Bay Mines Ltd.
Caribou-Smith Mines Ltd.
Centroamericana de Cobre, S.A.
Chile Copper Company
Cobre de Hercules, S.A.
Cobre de Mexico, S.A.
Cobrecel, S.A. de C.V.
Colonial Pipeline Company
Compania de Petroleo Ganso Azul, Ltda.
Compania Minera Dos Republicas, S.A. de C.V.
Compania Minera Kappa, S.A.
Compania Minera Penacobre, S.A.
Cook Inlet Pipe Line Company
Cupro San Louis, S.A. de C.V.
Curragh Coal Sales
Delaware Bay Transportation Company
Dexter de Mexico, S.A.
Dixie Pipeline Company
East Texas Salt Water Disposal Co.
85819 Canada Limited
Eisenhower Mining Company
Empresa de Comercio Exterior Mexicano, S.A. de C.V.
Energy Transportation Systems, Inc.
Ericsson, Inc.
Flower Street Limited
F.T.L. Company Limited
Gravity Adjustment, Inc.

Greater Pacific Limited
Griffith-Consumers Company
Hardy Oil Company
Imperial Eastman de Mexico, S.A.
Impulsora De Cobre, S.A. de C.V.
Industrias Nacobre, S.A. de C.V.
Industrias Tecnos, S.A. de C.V.
Iricon Agency Ltd.
Jamaica Alumina Security Company, Ltd.
Kenai Pipe Line Company
Kronos, Computacion y Teleproceso, S.A. de C.V.
Kuparuk Transportation Capital Corporation
Kuparuk Transportation Company
Las Quintas Serenas Water Company
Lavan Petroleum Co.
Lingobronce, S.A.
Manguera Flex, S.A. de C.V.
Manufacturera Mexicana De Partes Para
Automoviles, S.A. de C.V.
Mayflower Mining Company
R.W. Miller (Holdings) Limited
Minera Anaconda Limitada
Montoro, Empresa Para La Industria Quimica
Nacional de Cobre, S.A.
New Bingham Mary Mining Company
Nihon Oxirane Company, Ltd.
Nordisk Mineselskab A/S
Oil Shippers Service, Inc.
P.T. Arutmin Indonesia
Park City Ventures
Park Cummings Mining Company
Park Premier Mining Company
Participaciones Mexicanas, S.A. de C.V.
Platte Pipe Line Company
Prince Consolidated Mining Company
Productos Especiales Metalicos, S.A.
Richfield U.K. Petroleum, Limited
Rodman, Inc.

The Saudi Cable Company
Servicios Industriales Nacobre, S.A.
Sinclair U.K. Oil Company Limited
Sinclair Venezuelan Oil Company
Smoke House Copper Mining Company
Sociedada Anonima Marvin
Solar Energy Center (E.C.)
Solvamex, S.A. de C.V.
Sumiarco Company Limited
Swecomex, S.A.
Tecumseh Pipe Line Company
Texas-New Mexico Pipe Line Company
Trans Mountain Oil Pipe Line Company
Tubos Flexibles, S.A.
Union de Credito Industrial Vallejo, S.A.
United Park City Mines Company
The Walworth Company
West Mayflower Mining Company
William Prym de Mexico, S.A.

GETTY OIL COMPANY

The stock of Getty Oil Company has been acquired by Texaco Inc.

Getty Oil Company has no subsidiaries and affiliates which are not wholly owned whose securities are publicly traded in the United States or Canada.

The subsidiaries and affiliates (not wholly owned) of Texaco Inc., as reported in the petition for writ in No. 83-1171, are:

Caltex Australia Limited
Duetsche Texaco Aktiengesellschaft, S.I.A.M.
Koa Oil Company
Korea Tanker Company Limited
Texaco Canada Inc.
Texaco Ghana Limited

Texaco Mexicana, S.A. de C.V.
Texaco Nigeria Limited
Texaco Togo
The Great Eastern Oil & Import Co. Limited

MOBIL OIL CORPORATION

Mobil Oil Corporation is a wholly owned subsidiary of Mobil Corporation.

The subsidiaries and affiliates of Mobil Oil Corporation or Mobil Corporation, whose securities are available for purchase by United States citizens, are:

Marcor Inc.
Mobil Alaska Pipeline Company
Montgomery Ward & Co., Incorporated
Montgomery Ward Credit Corporation
Toa Nenryo Kogyo Kabushiki Kaisha

PHILLIPS PETROLEUM COMPANY

The subsidiaries and affiliates of Phillips Petroleum Company are:

Acurex Corporation
Arctic LNG Transportation Company
Bruin Carbon Dioxide Corporation
Calatrava, Empresa para la Industria Petroquimica, S.A.
Canyon Reef Carriers
Cochin Refineries Limited
East Texas Salt Water Disposal Company
Heat Transfer Research, Inc.
Kenai LNG Corporation
Oil Insurance Limited
Papago Chemicals, Inc.
Phillips Carbon Black Limited
Phillips Gas Supply Corporation
Phillips Pacific Chemical Company
Plasticos Vanguardia, S.A.

Polar LNG Shipping Corporation
The Salk Institute Biotechnology
White River Shale Oil Corporation
Aero Oil Company
Canada Western Cordage Company Limited
Chisholm Pipeline Company
Norsea Gas A/S
Phillips Carbon Black Company (Proprietary) Limited
Phillips Carbon Black Italiana S.p.A.
Phillips Petroleum Singapore Chemicals (Private) Limited
Everglades Pipe Line Company
Explorer Pipeline Company
Kaw Pipe Line Company
Nordisk Kemi AB
Nordisk Philblack AB
Norland GmbH Fur Grundbesitz Und Industrieanlagen
Norpipe Petroleum UK Limited
Norsea Gas GambH
Quimica Venoco C.A.
Renalit—Fertighaus GmbH
Seadock, Inc.
Seaway Pipeline, Inc.
Spodco-USA, Inc.
Texas Offshore Port, Inc.
Venezoil, C.A.
Western Desert Operating Petroleum Company
Colonial Pipeline Company
Compagnie Francaise Du Carbon Black
Dixie Pipeline Company
Drisco, S.A. de C.V.
Industrias Negromex, S.A. de C.V.
Petrochim
Spodco Limited
Trenwick Limited
Great Yarmouth Port Labour Company Limited

Norsea Pipeline Limited
Phillips-Imperial Petroleum Limited
(owned by Subsidiary of Phillips Petroleum Company United Kingdom Limited)
Philmac Oils Limited
Philmac Panama Incorporated
Sevalco (Holdings) Limited
Iranian Marine International Oil Company ("Iminoco")
Alyeska Pipeline Service Company
Insurance & Reinsurance Brokers (Bermuda) Limited
Norpipe a.s.

T.H. McELVAIN OIL AND GAS PROPERTIES, *et al.*

None of the parties to PLA-4 (T.H. McElvain Oil and Gas Properties, *et al.*) is a corporation. The list of the parties to PLA-4 which appears in the various Petitions for Certiorari should be corrected to read as follows:

T. H. McElvain Oil and Gas Properties
Grace M. Brown
Catherine B. McElvain
T. H. McElvain, Jr.
Catherine M. Harvey
James E. McElvain, Executor of Estate of Carl R. McElvain
Nancy Ridgely
Brenda V. Petke
James M. Raymond, as Trustee of Estate of F.B. Miller
Corrine Miller Gay Trust
Maydell Miller Mast Trust
Maybelle Miller Nestler Trust
Ruth M. Vaughn

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443 and 83-1618

NORTHWEST PIPELINE CORPORATION, *et al.*,
Petitioners,

v.

PHILLIPS PETROLEUM COMPANY, *et al.*,
Respondents.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF IN OPPOSITION OF THE PLA RESPONDENTS

Respondents Amoco Production Company, Atlantic Richfield Company, Getty Oil Company, Mobil Oil Corporation, Phillips Petroleum Company, and T.H. McElvain Oil and Gas Properties, *et al.* ("the PLA respondents") respectfully request that this Court deny the petitions for writ of certiorari seeking review of the judgment of the United States Court of Appeals for the Fifth Circuit in this case.[1]

---

[1] Petitions for a writ of certiorari have been filed by the People of the State of California, *et al.* ("California") (No. 83-1321); the Public Utility Commissioner of Oregon, *et al.* ("Oregon") (No. 83-1432); Northwest Pipeline Corporation, *et al.* ("Northwest") (No. 83-1433); El Paso Natural Gas Company ("El Paso") (No. 83-1442); Pacific Gas and Electric Company, *et al.* ("PG&E") (No. 83-1443); and the Federal Energy Regulatory Commission ("FERC") (No. 83-1618). Citations to the various petitions will be in the form "California Pet. at ——." The Appendix prepared by California will be cited as "Pet. App. at ——." A complete listing of all the parties to this case appears in the FERC Pet. at ii to xi.

STATEMENT OF THE CASE

A. Background of the Litigation

This case involves a series of agreements entered into in the 1950s by El Paso Natural Gas Company and Pacific Northwest Pipeline Corporation[2] with the holders of lease rights to possible gas-bearing lands in the San Juan Basin area of New Mexico and Colorado.[3] Under the agreements, the leaseholders conveyed to El Paso and Pacific Northwest the right to explore for and produce gas from certain geological formations underlying the leasehold acreage. In exchange, the leaseholders retained an overriding royalty on all gas produced by the pipelines from these leases. The overriding royalty in each agreement was stated in terms of cents per thousand cubic feet of gas, subject to escalation and possible redetermination at stated intervals of time. The agreements provided that the leaseholders were not to be involved in exploration or production; all such operations were to be performed by or on behalf of the pipelines. *See* Pet. App. at 126a-127a.

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[2] After the agreements were made and implemented, El Paso acquired Pacific Northwest. Subsequently, El Paso was ordered by this Court to divest its acquisition, *United States v. El Paso Natural Gas Co.*, 376 U.S. 651, 662 (1964); *see also Utah Public Service Commission v. El Paso Natural Gas Co.*, 395 U.S. 464 (1969); *Cascade Natural Gas Corp. v. El Paso Natural Gas Co.*, 386 U.S. 129 (1967), resulting in the creation of the present Northwest Pipeline Corporation in February 1974. The agreements originally made by Pacific Northwest, known as Pacific Lease Agreements (PLAs), were transferred to Northwest Pipeline at divestiture. The essentially identical agreements retained by El Paso are called Gas Lease Agreements (GLAs). *See* Pet. App. at 38a.

[3] These leaseholders (or their successors), which include both corporations and a large number of individuals, are the respondents in the present case. The parties sponsoring this Brief are denominated the PLA respondents because they have PLA agreements with Northwest. *See* note 2 *supra*. One of the PLA respondents, Atlantic Richfield Company, also has a GLA agreement with El Paso and therefore is a signatory of the separate Brief in Opposition of Respondents Tenneco Oil Company, *et al.*

From their inception, these agreements were treated by all concerned, including the Federal Power Commission,[4] as nonjurisdictional lease transactions, rather than sales in interstate commerce of natural gas for resale. In every pipeline rate case from the mid-1950s until this litigation was begun, the Commission reviewed and allowed in the pipelines' cost-of-service the overriding royalties paid by El Paso and Northwest. The Commission's lack of jurisdiction over the lease sales was never questioned in any of those cases.[5]

---

[4] Both the Federal Power Commission and its successor the Federal Energy Regulatory Commission will be referred to herein as "the Commission."

[5] In fact, the Commission's treatment of the lease sales as nonjurisdictional went beyond mere passive acquiescence. In *Phillips Petroleum Co.*, Opinion No. 338, 24 F.P.C. 537 (1960), *rehearing denied*, 24 F.P.C. 1008 (1960), *aff'd, Wisconsin v. FPC*, 303 F.2d 380 (D.C. Cir. 1961), *aff'd*, 373 U.S. 294 (1963), the first independent producer rate case at the FPC, the Commission carefully separated Phillips' jurisdictional costs for its wellhead sales of gas from its nonjurisdictional costs associated with its royalty interests, including primarily the San Juan Basin overriding royalties. *See* 24 F.P.C. at 557, 565; *see also id.* at 664-66 (hearing examiner's discussion of nonjurisdictional status of exploration costs relating to Phillips' PLA agreement). As late as 1973, the Commission expressly reaffirmed that these agreements were not the equivalent of jurisdictional sales of gas. *William G. Webb*, Opinion No. 642, 49 F.P.C. 17 (1973). Distinguishing the "Webb-Turner" lease-sale agreements, which are among those now before this Court, from the agreements held jurisdictional by this Court in *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965) (*"Rayne Field"*), the Commission held that the San Juan Basin agreements:

> represented a method evolved by El Paso and the Producers to cause the exploration for and the development of necessary gas supplies . . . . The transactions arose out of the needs of the parties rather than being almost wholly a rearrangement of payments, as in *Rayne*, to accomplish the same result as a conventional sale.

49 F.P.C. at 26.

B. The District Court Proceeding

In 1973, the overriding royalty under one of the agreements was increased substantially as the result of arbitration pursuant to the redetermination provision in the agreement. In reaction, El Paso filed a complaint in district court, alleging for the first time[6] that these transactions were subject to Commission jurisdiction as "sales of gas" under the Natural Gas Act.[7] Subsequently, El Paso and Northwest both filed complaints with the Commission, raising the same claim. The Commission, at the urging of its staff, refused to act on the complaints,[8] choosing instead to defer to the district court. *See* Pet. App. at 37a & n.7.[9]

In January 1977, following a lengthy trial, the district court ruled that these transactions were not jurisdictional under the Natural Gas Act. Pet. App. at 121a. Applying the principles of *Rayne Field*, *see* note 5 *supra*, the district court rested its decision on three major factors: (1) the absence of proven reserves at the time the agreements were made; (2) the lack of substantial development of the properties at that time; and (3) the fact that the lease sales were not the economic equivalent of conventional gas sales but were unique transactions formulated to meet the needs of the parties. *Id.* at 131a-133a.

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[6] In the *Webb* case, *see* note 5 *supra*, El Paso had urged the Commission to hold the lease sales nonjurisdictional.

[7] After the divestiture of Northwest by El Paso, *see* note 2 *supra*, Northwest joined the suit as a plaintiff.

[8] Significantly, the Commission staff took the position at the time that, if the Commission were to address the issue of jurisdiction, it should find the San Juan Basin lease sales nonjurisdictional. *See* Docket No. CP74-314, Staff's Comments to Complaint of El Paso Natural Gas Company and Request for an Order to Show Cause at 4-8 (July 19, 1974). The relevant portion of the staff's 1974 analysis of this issue is set forth in the Appendix to this Brief.

[9] Subsequently, El Paso and Northwest entered into interim settlements with the GLA and PLA royalty owners regarding the level of overriding royalties.

The court began its analysis by examining the agreements made with El Paso. On the issue of proven reserves, the court found that "[t]he GLAs in issue were not transfers of leases with proven reserves, since no reasonable estimate of recoverable reserves underlying the specific acreage conveyed could be made at the time [each] respective GLA was executed." *Id.* at 131a. With respect to substantial development, the court likewise determined that the GLA acreage fell short of meeting the jurisdictional test. "Where wells had been drilled," the court observed, "the number was exceptionally low compared to the number of available drilling sites. Wells in the Basin generally were incapable of recovering commercially significant amounts of gas." *Id.* at 132a. Moreover, the court found, "[t]he GLAs themselves indicate that the parties negotiated for undeveloped acreage. . . . Each transaction made sense economically, only if undeveloped acreage were transferred. . . ." *Id.* at 133a.

Regarding the final factor, economic equivalency to conventional sales, the court found the San Juan Basin lease sales distinguishable from the transactions held jurisdictional by this Court in *Rayne Field*. "The parties did not enter into the GLAs as a means of shifting payments as in *Rayne Field*," the court commented.[10] "Rather, these agreements arose from the unique economic situation of the parties and reflected their efforts to structure the transactions so that El Paso would explore for and de-

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[10] The district court rejected the assertion—advanced here by nearly all the petitioners—that the events concerning the Barker Dome Field, which preceded the transactions here at issue, evidenced an intent of the parties to the GLAs and PLAs to evade Commission jurisdiction. *See, e.g.*, El Paso Pet. at 4-6; FERC Pet. at 4-5. "[T]he history of the Barker Dome agreement is not analogous to the agreements here at issue," the court said. "The negotiations surrounding Barker Dome reflect El Paso's efforts to enter the San Juan Basin. Once El Paso was certified, it held a virtual monopsony in the Basin . . . ." Pet. App. at 125a n.5.

velop gas reserves in the Basin." *Id.*[11] The court made virtually identical findings with regard to PLA-13, the only Northwest agreement then at issue. *Id.* at 133a-134a.

Based on these findings, the district court concluded that the lease transactions were nonjurisdictional. "Because no agreement was the economic equivalent of a gas sale contract," the court stated, "and because the leases transferred were neither proven nor substantially developed at the time of the execution of those agreements, each agreement at issue in this litigation . . . is not a 'sale in interstate commerce of natural gas for resale' . . . ." *Id.* at 134a-135a.

C. The Commission Proceeding

After the district court issued its decision, the Commission instituted a show-cause proceeding to reconsider the question of its jurisdiction over the San Juan Basin lease sales.[12] A Commission administrative law judge reheard the issues raised in the district court and entered an initial decision contrary to the district court's opinion.

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[11] The district court explained that El Paso, which was regulated on a cost-of-service basis, could afford to explore for and produce gas in an area such as the San Juan Basin, while independent producers, who were limited by the price the pipeline was willing to pay, could not. Pet. App. at 128a n.13. The district court attributed the format of the lease sales to these economic circumstances and not to any intent to escape Commission regulation.

[12] Respondents filed a petition for review challenging the institution of the Commission proceeding on res judicata and collateral estoppel grounds. Without reaching the issues presented, the Fifth Circuit directed the Commission to proceed, and deferred action on the pipelines' appeal of the district court decision pending receipt of the Commission's opinion. Pet. App. at 137a. Because the Fifth Circuit ultimately decided the jurisdictional issue on the merits, it never reached the collateral estoppel and res judicata issues. Pet. App. at 19a.

The administrative law judge concluded that the lease-sale transactions were the economic equivalent of conventional gas sales and were therefore subject to the Commission's jurisdiction. Pet. App. at 33a-120a.

On September 25, 1980, the Commission reversed its stance of almost thirty years and adopted the initial decision as its own opinion.[18] Following the denial of rehearing, petitions for review of the Commission decision were filed and consolidated with the pipelines' pending appeal from the district court decision.

D. The Court of Appeals Decision

The court of appeals unanimously affirmed the district court's conclusion that these transactions were not jurisdictional, and reversed the Commission's contrary conclusion. It started with an examination of this Court's decision in *Rayne Field*, which it termed the "fountainhead decision setting forth the factors to apply in determining whether a transaction is jurisdictional." Pet. App. at 11a. In *Rayne Field*, the Fifth Circuit explained, the Supreme Court "directed a case-by-case analysis of hybrid lease-sale arrangements, the fundamental inquiry being whether 'the sales of these leases in . . . a proven and substantially developed field . . . accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states.' " *Id.* at 12a, quoting 381 U.S. at 401. Relying on its decision in *Continental Oil Co. v. FPC*, 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910 (1967) ("*Ship Shoal*"), the court of appeals found three factors to be relevant to the *Rayne Field* determination: (1) whether "the economic effect of the transfer [is] similar to that of a conventional sale"; (2) whether "the subject of the transaction [is] 'proven and substan-

[18] In its order, the Commission initiated a remedy proceeding to determine whether any refunds were due as a result of its jurisdictional finding, the amount of any such refunds, and the level of future overriding royalties. The remedy proceeding was suspended immediately following the Fifth Circuit's decision.

tially developed' reserves"; and (3) whether "the transfer of the reserves [is] for [the] purpose of interstate transmission and resale." Pet. App. at 12a, quoting 370 F.2d at 62.[14]

Applying this test to the facts at hand, the court of appeals discerned a fundamental error in the Commission's approach to the jurisdictional issue. "In determining whether a transfer is jurisdictional under the [Natural Gas] Act," the court stated, "*Ship Shoal* teaches that all three of the above factors must be present. The administrative law judge and the Commission, however, elevated the first prong—economic equivalency—from a component in the *Rayne Field* test to the determinative factor on the issue." Pet. App. at 12a-13a. "Carried to its logical conclusion," the court reasoned, "the Commission's economic equivalency/commercial realities approach could render any sale of lease rights to an interstate pipeline company jurisdictional merely because the transaction ultimately results in successful production and disposition of gas in interstate commerce." *Id.* at 14a.

Because its opinion focused on this critical flaw in the Commission's reasoning, the Fifth Circuit had no occasion to address two of the district court's principal findings, namely, that the lease-sale agreements were not economically equivalent to conventional gas sales and that they did not constitute transfers of proven reserves.[15] Instead, the court of appeals affirmed the result reached

[14] The court further noted that, under *Ship Shoal*, the "proven and substantially developed" test has two aspects: "(1) definability of gas volume based upon proof of reserves and (2) imminent ability to produce in commercial quantities." Pet. App. at 12a, citing 370 F.2d at 63-64.

[15] While the court of appeals did comment in passing that "the reserves in the Basin may well have been 'proven' at least within reasonable estimates," *id.* at 15a, the court did not address the question directly, nor did it overturn the district court's finding that the reserve estimates at the time covered the entire San Juan Basin, leaving the volume of reserves underlying particular tracts highly uncertain. *See id.* at 131a n.19.

by the district court solely on the ground that "the lease-sale agreements did not involve substantially developed reserves, and the Commission erred in determining [that they] did." *Id.* at 15a. Expressly adopting the district court's finding that "actual drilling is the only method of definitely locating recoverable gas saturations [in the San Juan Basin]," *id.* at 9a, the Fifth Circuit found the "limited extent to which the Basin had been drilled at the time the GLAs and PLAs were executed" an "important factor" in evaluating whether the agreements were jurisdictional, *id.* at 15a. "While the number of wells existing at execution of the agreement is not the *sine qua non* of substantial development," the court stated, "the Commission has considered this factor, and the cases point up its significance." *Id.* at 16a, citing *Rayne Field* and *Texas Gas Transmission Corp.*, 3 FERC ¶ 61,135 (1978). Since the evidence below revealed that "the few wells in the ground when the agreements were executed could not have come close to depleting the acreage," Pet. App. at 16a,[16] the court of appeals concluded that "the acreage was not substantially developed [and] the agreements in issue were not sales of gas under the Natural Gas Act," *id.* at 17.

Petitioners sought rehearing and rehearing *en banc* of the unanimous decision of the Fifth Circuit panel. Despite petitioners' vigorous assertions of an intracircuit conflict (which they have renewed here), the requests for rehearing and rehearing *en banc* were denied on December 2, 1983, without having attracted any votes. Pet. App. at 152a. Petitions for a writ of certiorari were subsequently filed by six separate parties or groups of parties. *See* note 1 *supra*.

[16] In fact, the court noted, a number of the agreements covered acreage on which no wells existed at the time of execution. The Phillips PLA, for example, involved 188,000 acres which did not contain a single well. *Id.* at 16a. By 1977, 365 wells had been drilled on this acreage, *id.*, and the number has increased substantially since then.

SUMMARY OF ARGUMENT

It is well-established that while the Natural Gas Act vested the Commission with jurisdiction over wellhead sales of gas in interstate commerce, transfers of gas leases are normally outside the Commission's jurisdiction. *Compare, e.g., Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), *with Mobil Oil Corp. v. FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972). An exception is made when the conveyance of a gas lease in a "proven and substantially developed field" transfers an agreed-upon volume of gas reserves in place. When such a transaction is the functional equivalent of a wellhead sale of gas, this Court has held that it can constitute a jurisdictional sale. *Rayne Field*, 381 U.S. at 401.

Applying the *Rayne Field* standard, the courts below held that the lease-sale transactions at issue here were not sales of gas under the Natural Gas Act. Contrary to petitioners' assertions, this decision does not present an issue of broad legal significance, nor does it threaten to undercut Commission jurisdiction or to inflict significant financial harm on gas consumers.

The Fifth Circuit's decision is fully consistent with other cases in this well-defined field of law and plainly does not alter the jurisdictional standard established by this Court in *Rayne Field*. Petitioners have not advanced any persuasive argument to justify abandonment of the *Rayne Field* test. Their proposal to delete the "proven and substantially developed" element from the jurisdictional standard disregards the express statutory limitations on Commission jurisdiction and ignores the key role this requirement plays in the determination whether what is sold is gas, or merely the right to find and produce gas. Indeed, the Commission itself has recognized that, in the absence of substantial development, no "sale of gas" within the meaning of the Natural Gas Act is possible. *See Texas Gas Transmission Corp.*, 3 FERC ¶ 61,135 (1978).

In addition, the unique circumstances presented here, together with recent developments in the field of natural gas regulation, strongly indicate that this case is now *sui generis*. This Court's decision that the first-sale provisions of the Natural Gas Policy Act of 1978 ("NGPA"), Pub. L. No. 95-621, 92 Stat. 3350, 15 U.S.C. §§ 3301 *et seq.*, apply to pipeline-produced gas, *Public Service Commission v. Mid-Louisiana Gas Co.*, 103 S. Ct. 3024 (1983), makes it highly unlikely, for practical reasons, that the issue raised here will ever recur. Furthermore, even if this issue were to arise again, the enactment of the NGPA has substantially altered the statutory scheme under which it would be decided. There is thus no need for this Court to make elaborate refinements on the jurisdictional standard applicable under the Natural Gas Act, nor is there any prospect that an "attractive gap" will be opened in the regulatory scheme.

Petitioners contend that, unless overturned, the decision below will cause serious financial harm to gas consumers on the West Coast. To the contrary, there is no significant prospect that the decision will increase the future cost of gas to consumers. Nothing in the decision below affects the Commission's longstanding jurisdiction to control the rates the pipelines charge their customers. Moreover, absent extraordinary Commission action, consumers cannot be required to pay more for this gas than the applicable NGPA ceiling prices, regardless of the outcome of this case. Given additionally that the prospect of retroactive refunds in this case is at best highly speculative, the claim that the public will suffer if the decision below is not reversed must be viewed with great skepticism.

In summary, the decision below has little precedential significance. It will not affect the scope of Commission jurisdiction in the future, nor does it open any gap in the regulatory scheme. Its impact, either prospective or retroactive, on the gas-consuming public is minimal. For these reasons, review by this Court is both unnecessary and unwarranted. The petitions for certiorari should therefore be denied.

REASONS FOR DENYING THE WRIT

I. PETITIONERS HAVE PRESENTED NO SIGNIFICANT LEGAL ISSUE WARRANTING THIS COURT'S ATTENTION

The issue in this case is whether, under section 1(b) of the Natural Gas Act, the particular lease-sale transactions involved here are subject to the jurisdiction of the Commission. The courts below, applying the established *Rayne Field* test, held that they are not. Petitioners challenge that determination on two basic grounds: first, that the *Rayne Field* test is wrong and should be rev'sed, and second, that even if *Rayne Field* articulated the proper jurisdictional test, the court below misapplied that test. Neither of these contentions raises an issue worthy of this Court's review.

A. The *Rayne Field* Test, Including the 'Proven and Substantially Developed' Element, Is the Proper Jurisdictional Standard

Petitioners are virtually unanimous in suggesting that this Court should eliminate one of the key elements of the *Rayne Field* test, namely, the requirement that the reserves in question be substantially developed. El Paso's petition states, for example, that "it makes no sense to require that the lease sale acreage be substantially drilled." El Paso Pet. at 14; *see also* California Pet. at 15; Northwest Pet. at 24.[17] Petitioners apparently would prefer a test under which any conveyance of an interest in possible gas-bearing lands would be subject to Commission jurisdiction if the transaction ultimately leads to

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[17] El Paso, like several of its co-petitioners, painstakingly edits out the critical language from the Court's statement in *Rayne Field* that the lease sales there, which involved *"a proven and substantially developed field,* accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States." 381 U.S. at 401 (emphasis added). *Compare* El Paso Pet. at 14; Northwest Pet. at 18; California Pet. at 17 (all omitting the phrase italicized above).

the production of gas for sale in interstate commerce by a natural gas pipeline company.

Contrary to petitioners' assertions, however, the "proven and substantially developed" test is a well-established and essential component of the jurisdictional standard under the Natural Gas Act. *See Rayne Field*, 381 U.S. at 401-03; *Ship Shoal*, 370 F.2d at 62. It is a critical element in distinguishing nonjurisdictional land transactions from jurisdictional sales of natural gas. The function of this test is to determine, precisely as the Commission has stated the issue in its petition, "whether what [is] sold [is] gas or merely the right to explore for gas." FERC Pet. at 19.

The test reflects the elementary fact, accepted everywhere in the industry, that the question whether, and to what extent, gas underlies particular acreage cannot be answered in the absence of actual drilling which penetrates the gas-bearing sands.[18] It is this penetration of productive sands which permits a determination (by core analysis, electric log or other means) of the actual presence of natural gas. Absent such a determination, there plainly cannot be a "sale of gas" over which Congress has given the Commission authority.[19]

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[18] The disclosure regulations of the Securities and Exchange Commission, for example, limit the classification of reserves as "proved" to those areas of a reservoir "delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, and . . . the *immediately adjoining* portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geological and engineering data." 17 C.F.R. § 210.4-10(a)(2)(i) (1983) (emphasis added). Natural gas "that may occur in undrilled prospects" cannot be classified as "proved reserves." *Id.* § 210.4-10(a)(2)(iii)(C); *see also id.* § 210.4-10(a)(4). The standards for "proved, developed" reserves are even more stringent; only "reserves that can be expected to be recovered through existing wells with existing equipment" can be classified as "proved, developed." *Id.* § 210.4-10(a)(3).

[19] The "proven and substantially developed" test reflects this basic physical fact. The mere presence of geology favorable to the

This Court recognized as much in its landmark decision in *Rayne Field*. First, the Court linked the substantial development of the Rayne Field reserves to the "significant and determinative economic fact" that the lease sales "in Rayne Field, *a proven and substantially developed field*, accomplished the transfer of large amounts of natural gas to an interstate pipeline company." 381 U.S. at 401 (emphasis added). The Court thus acknowledged that the Rayne Field lease sales would not have been sales of *gas* without substantial development which permitted verification of the estimated reserves thought to underlie the acreage.

Second, the *Rayne Field* Court expressly relied on the substantial development of the Rayne Field reserves to distinguish *FPC v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949), which had held that sales of undeveloped leases fall within the "production or gathering" exemption of section 1(b). 381 U.S. at 403-04. *Panhandle*, the Court said, did not pose the "present problem—whether the transfer to an interstate pipeline company for transmission and resale in interstate commerce of *proven and substantially developed* gas reserves is subject to Commission jurisdiction." *Id.* at 404 (emphasis added). As the Court explained:

> The substantiality of development is a relevant consideration for the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce which . . . the Act has affirmatively placed within Commission jurisdiction.

Id. at 403.[20]

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accumulation of gas does not insure that there is a commercial accumulation, or indeed any accumulation at all. This is attested to by the fact that dry holes are frequently drilled, even in producing fields.

[20] The Commission argues that, while substantial development is "a relevant consideration," it cannot be the dispositive factor in a

The Commission itself has recognized that substantial development is a crucial component of the jurisdictional test. In *Texas Gas Transmission Corp.*, 3 FERC ¶ 61,135 (1978), the Commission held a sale of reserves in place nonjurisdictional on the ground that the reserves were not substantially developed.[21] The issue of the importance of the substantial development test thus does not raise a serious legal question requiring this Court's attention.

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particular case. FERC Pet. at 14-15 (emphasis in original). The import of this distinction is unclear: if the substantiality of development can never affect the outcome of a particular case, it is hard to see how it is relevant. In any event, the Commission's contention that substantial development cannot be viewed as "an essential predicate to jurisdiction," *id.* at 15, is not supported by the evidence cited. The observation, for example, that a sale of natural gas can occur " 'before production or gathering is ended,' " *id.*, quoting 381 U.S. at 402, merely indicates that, under certain circumstances, a jurisdictional sale can involve gas that is still in the ground. This principle in no way contradicts the basic *Rayne Field* standard that one of the characteristics defining a jurisdictional sale of gas in place is substantial development through drilling, for the sale of a defined volume of gas in the ground was precisely what *Rayne Field* involved. The same holds for the Commission's observation that the production and gathering exemption relates to the physical process of producing and gathering gas. FERC Pet. at 15, citing 381 U.S. at 402. That truism notwithstanding, substantial development is a logical, firmly grounded prerequisite to the existence of a jurisdictional sale of gas in place.

[21] As the Commission stated:

> Since the [sellers] had not sufficiently developed the field to be able to conduct economically feasible wellhead arrangements, [they] could not have made a conventional wellhead sale to [the buyer] if the parties had so desired. Only 14 wells had been completed, and only 10 of these were productive . . . . Clearly, these are essentially undeveloped reserves requiring further development for feasible production. . . . [I]n our view, the sale of [these] reserves . . . does not constitute a sale for resale in interstate commerce requiring a certificate under Section 7(c) of the Natural Gas Act.

Id. at 61,405-06.

B. The *Rayne Field* Test As Applied Here Does Not Leave an 'Attractive Gap' in the Regulatory Scheme

As shown above, the *Rayne Field* test is the proper standard for judging the jurisdictionality of lease-sale transactions under the Natural Gas Act. Of perhaps equal importance to this Court, the issue of the proper standard under that Act no longer has any real significance beyond the unique facts of this case. Indeed, petitioners have failed to show in any way that the existing *Rayne Field* test leaves an "attractive gap" in the regulatory scheme.

This is so for two major reasons. First, the Natural Gas Act has ceased to be the only statute defining the scope of federal jurisdiction over sales of natural gas. With the enactment of the NGPA in 1978, Congress "comprehensively and dramatically changed the method of pricing natural gas produced in the United States." *Public Service Commission v. Mid-Louisiana Gas Co.*, 103 S. Ct. 3024, 3026 (1983). In particular, while preserving "the Commission's authority under the [Natural Gas Act] to regulate natural gas sales from pipelines to their customers," the NGPA was "designed to supplant the Commission's authority to establish rates for the wholesale market, the market consisting of so-called 'first sales' of natural gas." 103 S. Ct. at 3031. The NGPA explicitly describes the "first sales" subject to its coverage as including the sale of "proven reserves in place." 15 U.S.C. § 3301(22).[22]

Consequently, even for transactions properly characterized as transfers of gas in place, the judicially devel-

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[22] Because this provision applies only to the "transfer of title" to reserves, *id.*, it is inapplicable to the GLA and PLA agreements. Even if those transactions could be found to have involved "proven reserves," *compare* Pet. App. at 131a, the transfer of title under the GLAs and PLAs took place several decades before enactment of the NGPA.

oped jurisdictional test under the Natural Gas Act has been supplemented—if not supplanted—by a newly applicable statutory standard. Further refinements on the jurisdictional principles relevant under the prior statute are therefore of limited utility. Since the Natural Gas Act test established in *Rayne Field* does not control the jurisdictionality of lease sales occurring after November 8, 1978, *see* 15 U.S.C. § 3431(a)(1)(A), the relevance of the decision below is effectively confined to the GLA and PLA agreements here, and to comparable transactions, if any exist, that were consummated before the NGPA took effect.[23]

The second reason that the issue raised here lacks broad significance relates to this Court's recent decision in *Mid-Louisiana*, 103 S. Ct. 3024 (1983). By holding in that case that the NGPA's "first sale" definition includes pipeline-produced gas, the Court ensured that NGPA ceiling prices would be applicable whether particular gas reserves were produced by a pipeline or by an independent producer. As the Commission concedes in its brief, "If

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[23] As a factual matter, lease-sale transactions comparable to those in *Rayne Field* have been a relative rarity in the industry. El Paso, for example, cites five, the most recent of which occurred in the early 1960s. El Paso Pet. at 13 n.14. As the district court's opinion clearly indicates, repetition of the specific type of transaction involved in this case is even more unlikely. *See, e.g.*, Pet. App. at 125a-134a. Unique circumstances existing in the San Juan Basin in the early 1950s gave rise to equally unique transactions. These circumstances included the existence of a potentially large but untapped source of gas; the unusual geology of the Basin; El Paso's need for a reliable gas supply to serve the expanding post-World War II California market; El Paso's dependence at the time on frequently interrupted sources of gas produced from wells that were primarily devoted to oil production; the low ratio of gas prices to oil prices; the market power of the pipelines as sole buyers of gas in the Basin; and the lack of incentive for independent producers to incur the costs of developing the San Juan Basin at then-prevailing wellhead prices as compared to the incentive of the pipelines, which could price their production on a cost-of-service basis.

the lease transactions are deemed to be nonjurisdictional, then under *Mid-Louisiana* the pipelines' sales of their production would be considered first sales within the meaning of the NGPA and the pipelines could charge their customers only the applicable NGPA rate . . . ." FERC Pet. at 21. Since NGPA pricing would also be applicable if the lease sales were found jurisdictional, it is now essentially immaterial to the nation's gas consumers which result obtains. Given that the underlying rationale of both the Natural Gas Act and the NGPA is consumer protection, *see Mid-Louisiana*, 103 S. Ct. at 3042 (White, J., dissenting), the issue of jurisdictionality, at least in the kind of circumstances presented here, has become largely irrelevant.

The Commission suggests that the issue is still alive by pointing out that, if a particular lease transaction is held nonjurisdictional, the pipeline involved may find itself with a royalty obligation in excess of the price it can charge its customers. FERC Pet. at 21.[24] Rather than permitting its stockholders to absorb excess royalty costs, it is asserted, the pipeline might seek to shift the burden onto its customers by requesting special relief from the Commission. *Id.* This contention ignores the critical role of the Commission as a guardian of the public interest. Only the Commission has the authority to permit collection of prices in excess of the NGPA statutory ceilings. *See, e.g.*, 15 U.S.C. § 3314(2); *see also Mid-Louisiana*, 103 S. Ct. at 3032; *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 328 (1974). No pipeline could enter into a lease-sale transaction with any reasonable expectation

[24] This possibility is largely theoretical. Both of the pipelines involved in this case have actively sought NGPA pricing for their gas, including the production from the PLA and GLA acreage. El Paso has estimated that if these lease sales were to be held jurisdictional, it would gain as much as $4.6 billion in added revenues from the application of NGPA pricing, rather than cost-of-service pricing. Even if the lease sales are not jurisdictional, however, El Paso stands to gain only about 17 percent less.

that it would automatically be able to pass through to its customers royalties in excess of NGPA prices. *See FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517-19 (1979).

As a result, it is very doubtful that the issue presented here will ever arise again. The NGPA controls the price that pipelines may charge for their own production. If a pipeline were to agree to pay royalties in excess of the NGPA ceiling price, that would be a matter to be resolved between the pipeline and the royalty owner. The consumer could not be charged a penny more than the statutory ceiling price without express Commission approval.

C. The Decision Below Is Not in Conflict with Other Decisions

Once petitioners move beyond their contention that the *Rayne Field* test should be reformulated, their attack on the decision below reduces to a claim that the court of appeals deviated from the approach allegedly taken in other cases and misapplied the *Rayne Field* test to the facts presented here. Not only are the claimed conflicts simply nonexistent, but the entire question of the Fifth Circuit's application of the *Rayne Field* test is a highly fact-specific issue unworthy of review by this Court.[25]

The principal conflict asserted by petitioners involves the *Ship Shoal* case, another Fifth Circuit decision applying *Rayne Field*. *Ship Shoal*, however, like *Rayne Field*, and its companion case, *FPC v. Pan American Petroleum Corp.*, 381 U.S. 762 (1965) (*"Bastian Bay"*), is plainly distinguishable. *Ship Shoal* involved a 3,000-acre tract on which some 17 wells had been drilled over a five-year period, including seven oil wells with 17 completions and one gas well with two completions. 370 F.2d at 59-60.

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[25] That the issue is essentially factual was acknowledged by El Paso in its Answering Brief in the court below. "While ultimately an issue of law," El Paso contended, "the jurisdictional issue is *fact-intensive*." Answering Brief of El Paso, *et al.*, at 4 (emphasis added).

"Gas was found in 46 reservoirs in 39 distinct sand zones," the court observed. "Later, drilling on five potential gas wells was commenced but completion was deferred." *Id.* at 60.[26] The FPC hearing examiner found that "the Ship Shoal gas had been 'ready for action since 1960.'" *Id.* at 65. Moreover, witnesses for the lease sellers "did not refute the evidence of Ship Shoal's imminent ability to produce gas in commercial quantities." *Id.* Based on findings such as these, the *Ship Shoal* court had no difficulty determining that the field was "proven and substantially developed" under the *Rayne Field* test. *Id.* at 66.

The facts in *Rayne Field* and *Bastian Bay* are similarly illuminating. In *Rayne Field*, 19 of a possible 26 wells had been drilled on the acreage conveyed by the agreement. *See id.* at 64. The Commission considered this a "'fully developed'" field. *Id.*, quoting *Texas Eastern Transmission Corp.*, 21 F.P.C. 860, 861 (1959). In *Bastian Bay*, 32 of a possible 39 wells had been drilled, with 21 oil completions and 20 gas completions. 370 F.2d at 64.

In this case, by contrast, only 42 wells had been drilled on the 375,000 acres conveyed by the PLA lease sales at the time of execution of the respective agreements, an average of less than one well for each 8,900 acres.[27] The

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[26] Petitioners argue that the presence of only one dually-completed gas well on the Ship Shoal acreage indicates that the development of gas there was negligible, and thus that substantial development was not actually required in that case. *See* Northwest Pet. at 21; El Paso Pet. at 15 n.16. This contention overlooks the fact that the existence of gas in numerous reservoirs had been demonstrated by drilling. Indeed, the drilling had enabled the parties to agree upon a definite volume of reserves in place that were purchased for cash at closing—a factor not present in any of the PLAs or GLAs.

[27] Similarly, as the court of appeals noted, GLA-47, the largest El Paso agreement, covered more than 102,000 acres, on which there were only 24 wells at the time of signing of the agreement, approximately one for each 4,250 acres. Pet. App. at 15a-16a. By

largest Northwest agreement, PLA-5, provided a "dramatic example of the lack of substantial development" of the properties. *Id.* "At the time of the agreement," [28] the Fifth Circuit noted, "there were no wells on the 188,000 acres [of PLA-5].[29] By December 1977, however, 365 wells were productive." Pet. App. at 16a. The starkly contrasting fact patterns of these cases belie petitioners' claim that the decision below is in conflict with the *Rayne Field-Bastian Bay-Ship Shoal* trilogy of cases.[30]

1976, more than 700 wells had been drilled on the GLA-47 acreage. *Id.* at 16a.

[28] Northwest argues strenuously that the court of appeals should have judged the substantiality of development of the lease-sale acreage at the time the PLA agreements were closed rather than at the time they were executed. *See* Northwest Pet. at 26-29. This argument misses an essential point. Following execution, unless the agreements were defeated because Pacific Northwest was unable to obtain financing and regulatory approval for its pipeline proposal, the agreements were not conditional. Thus, once the agreements were executed, the lease sellers parted forever with the right to explore for and produce any gas underlying the subject acreage, unless Pacific Northwest proved unable or unwilling to satisfy its obligations. As a result, any post-execution development of the properties was undertaken solely for the benefit of the pipeline. The court of appeals was thus correct in focusing on the date of execution of the lease sales as the relevant time to determine Commission jurisdiction over the lease sellers. In any event, use of a later date would have made no difference. Northwest itself admits there were only 124 PLA wells on the various closing dates, Northwest Pet. at 28, less than one well for each 3,000 acres of the almost 375,000-acre PLA leaseholds, and far fewer than the 365 wells drilled on PLA-5 alone by 1977. *Cf.* Pet. App. at 16a.

[29] One witness characterized Amoco's PLA acreage as "an awful lot of goat pasture." R. 1701. After execution of the agreements and the transfer of acreage, the pipelines, in fact, reassigned to the respondents substantial portions of the acreage originally conveyed. For instance, over one-half of Mobil's acreage was reassigned within six years of the transfer. R. 345. By 1957, 29 percent of the 145,984 acres originally assigned by Amoco had been reassigned to it by the pipeline. R. 14,641-42.

[30] As the district court found, these cases are distinguishable on other grounds as well. *See* Pet. App. at 127a n.11, 133a.

Petitioners' other asserted conflicts are even less plausible. Several petitioners contend, for example, that the Fifth Circuit decision here is contrary to the decision of the same court in *Louisiana Land & Exploration Co. v. FERC*, 574 F.2d 204 (5th Cir. 1978), *cert. denied*, 439 U.S. 1127 (1979). *See, e.g.*, Northwest Pet. at 20 n.13; El Paso Pet. at 23; *cf.* FERC Pet. at 19. That case, however, involved a lessor's attempt to control the incidents of a sale of "proven and developed" reserves by its lessee. 574 F.2d at 208. Not only is that a very different issue from the one presented here, but two of the circuit judges who decided the *Louisiana Land* case also joined in the decision below. The contention that these two cases cannot be reconciled is thus frivolous at best.

Equally contrived is the argument that the decision below conflicts with *Cities Service Gas Co. v. FPC*, 424 F.2d 411 (10th Cir. 1969), *cert. dismissed*, 400 U.S. 801 (1971). *See* El Paso Pet. at 22; FERC Pet. at 17-18. That case involved the issue whether the spin-off of producing properties from a regulated pipeline to a nonaffiliated gas producer should permit the pipeline to charge its customers the price stipulated in its contract with the nonaffiliated company, rather than the lower cost-of-service price previously charged. *Id.* at 416-17. The Tenth Circuit's refusal to permit this transparent evasion of Commission regulation is perfectly consistent with the result reached below. Indeed, the Tenth Circuit expressly noted that, even if the Commission "had no authority over the spin-off of undeveloped gas leaseholds," it still had the power to remedy "the *consequences* of such action if it causes a detriment to the pipeline's ratepayers." *Id.* at 416 (emphasis added). In other words, whatever the Commission's authority to regulate the price collected by the nonaffiliated producer, it plainly retained the power to protect consumers by regulating the rates charged by the pipeline. As *Cities Service* indicates, such a situation is perfectly compatible with the regulatory scheme established under the Natural Gas Act.

Finally, the asserted conflict with *Mobil Oil Corp. v. FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972), simply does not exist. In *Mobil*, the court of appeals turned aside an effort by the Commission to extend its jurisdiction under the Natural Gas Act to encompass virtually all gas royalty agreements.[31] The Commission's desire to protect consumers, the court observed, "is not sufficient justification upon which to base an expansion of the Act to activities clearly not within its terms. Congress did not give the FPC carte blanche to take whatever action it might consider appropriate in furtherance of this purpose." 463 F.2d at 263. Distinguishing *Rayne Field* as a case involving "gas reserves [that] were known and had been substantially developed," the court held that an ordinary gas lease, which "transfers only the right to explore, develop, and market if exploration is successful," *id.* at 262, is not jurisdictional. The court noted that, just as in this case, "no royalty is paid if no gas is discovered." *Id.*[32]

In summary, the Fifth Circuit properly applied the correct jurisdictional standard in determining that the

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[31] Northwest and El Paso allege an inconsistency between respondents' position in the present case and the position taken by some respondents in an unrelated set of petitions for certiorari in *Ashland Oil Co. v. Good*, No. 83-1234; *Mobil Oil Corp. v. Batchelder*, No. 83-1248; and *Cities Service Oil Co. v. Matzen*, No. 83-1278. *See* Northwest Pet. at 25 n.18; El Paso Pet. at 17 n.20; *cf.* FERC Pet. at 22 n.17. The issue in those cases, however, is not whether lease transactions are subject to Commission jurisdiction under the Natural Gas Act, but the level of royalties payable under leases containing a "market value" clause. *See Matzen v. Cities Service Oil Co.*, 233 Kan. 846, 667 P.2d 337 (1983) (cert. pending). Contrary to petitioner's contentions, there is no conflict in the positions of the respondents involved in these two cases.

[32] The overriding royalties here are plainly payable only for gas actually produced; there were no up-front payments of the kind found in *Rayne Field*, *Bastian Bay*, *Ship Shoal*, and the Barker Dome transaction. *See* Pet. App. at 127a & n.11.

lease transactions here were not "sales of gas" under the Natural Gas Act. Its decision is not in conflict with the decisions of other courts, nor does it raise any question of law having general significance for other pending or future cases. Indeed, because of (1) the unique facts presented here, (2) the enactment of the NGPA and (3) this Court's decision in the *Mid-Louisiana* case, the decision below deals with a situation that is highly unlikely ever to recur, and which therefore does not warrant this Court's attention.

II. THIS DECISION WILL NOT ADVERSELY AFFECT THE PUBLIC INTEREST

Frustrated in their efforts to demonstrate that this case raises a legal issue worthy of review by this Court, petitioners emphasize what they contend will be the adverse impacts of the decision below on the general public. These highly exaggerated assertions do not enhance petitioners' claims.

First, several petitioners charge that the decision below will "preclude the Commission from effectively regulating the rates charged for gas produced from fields that are major sources of supply for the two major interstate pipelines that serve the western United States." FERC Pet. at 11 (footnote omitted); *see also* California Pet. at 13; Northwest Pet. at 16; Oregon Pet. at 11. This assertion is nonsensical. The thrust of the litigation initiated by the pipelines was an attempt to convert land transactions which are not regulated into sales of gas which are regulated. The courts below held that, on the facts presented, the pipelines did not make their case. That the respondents are not subject to Commission regulation, however, does not mean that the rates charged to consumers are not regulated.

In point of fact, the two pipelines have operated the San Juan Basin properties for more than thirty years, producing the gas into their systems under Commission regulation and review of the cost to their customers. The Fifth Circuit decision does not alter or restrict in any way the power of the Commission to continue regulating the cost to the pipelines' customers of the production from the leases in question. Moreover, this Court's decision in the *Mid-Louisiana* case, *see* Part I.B. *supra*, ensures that absent extraordinary relief from the Commission the pipeline production involved here will be subject to NGPA pricing. Thus, the decision below in no way limits the Commission's ability to afford West Coast consumers "a complete, permanent, and effective bond of protection from excessive rates and charges." *Atlantic Refining Co. v. Public Service Commission*, 360 U.S. 378, 388 (1959).

Petitioners also allege that the decision below has deprived western gas consumers of refunds amounting to as much as $1 billion for past periods. *See, e.g.*, FERC Pet. at 21. Petitioners fail to acknowledge, however, the extreme unlikelihood that refund of such amounts would ever be required, even if the decision below were overturned. First, only one aspect of the complex jurisdictional question is presented here. Even if this Court were to rule in favor of petitioners, the case would still have to be remanded for resolution of a long list of other difficult issues, including the res judicata and collateral estoppel questions presented by the conflicting decisions of the district court and the Commission. *See* Pet. App. at 8a-9a; *see also* note 12 *supra*.[33] Only if all these issues were resolved in the pipelines' favor would the question of refunds even arise.

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[33] Respondents have not raised these questions here inasmuch as they were not addressed by the court below.

Further, the amount of refunds, if any, is highly controverted. Various parties submitted refund claims in the remedy proceeding instituted after the Commission's jurisdictional determination, *see* note 13 *supra*. Those claims were being vigorously contested at the time the Fifth Circuit issued its decision. The evidence offered by the respondents showed that they had, in fact, received *less*, not *more*, under the lease-sale transactions than they could have received as conventional sellers under the Natural Gas Act and the NGPA.[34] An additional indication of the questionable nature of the pipelines' refund claims is provided by the settlement agreement entered into by Northwest with Phillips, a principal PLA respondent. Under that settlement, the maximum refund liability, even assuming the PLAs are found jurisdictional, is approximately $30 million, a fraction of the refund amounts originally sought by Northwest and other parties.[35]

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[34] *See* Prepared Direct Testimony of John M. Little, *El Paso Natural Gas Co., et al.*, Docket Nos. CP74-314, *et al.* (filed Jan. 3, 1983). In addition, it should be noted that even before the *Mid-Louisiana* decision, Northwest had availed itself of the option offered by the Commission to price its gas production from post-1972 wells at the applicable national rates or NGPA ceiling prices. As a result, any refunds paid to Northwest would *not* be flowed through to Northwest's customers except to the extent they related to gas from pre-1973 wells.

[35] Northwest has entered into final and complete settlements with Phillips and Getty. The settlements provide that, if these lease-sales are ultimately held to be jurisdictional, Phillips and Getty would make refunds of approximately $30 million and $2 million, respectively, to Northwest. Neither settlement was opposed by Northwest's customers or the relevant state commissions. The Commission has given both settlements final approval and has terminated with prejudice the proceedings as to Phillips and Getty. Docket Nos. CP74-314, *et al.*, Order Approving Settlement Agreement (Nov. 23, 1983) (Phillips); Order Approving Settlement Agreement (Mar. 30, 1984) (Getty).

Finally, there is a substantial question whether the Commission's equitable power to order retroactive refunds should be exercised at all in a case such as this where two courts have found that the Commission lacks jurisdiction, and where the Commission itself has previously held the very transactions at issue nonjurisdictional. *See Transportation Enterprises, Inc. v. NLRB*, 630 F.2d 421, 426 (5th Cir. 1980). Since even the Commission's order instituting the remedy proceeding left open the possibility that refunds might not be ordered, *see* Pet. App. at 30a, it is evident that the entire question of refunds is highly speculative, and the amount even more speculative.

In short, the Fifth Circuit's decision will have no real impact on the consumers of this gas or on the public generally. The only significant effect of the decision is to thwart the pipelines' attempt to escape their obligations under the lease agreements. Petitioners' unfounded and exaggerated cries of alarm should not persuade this Court to grant review in a case that presents no issue warranting its attention.

CONCLUSION

For these reasons, the petitions for a writ of certiorari should be denied.

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APPENDIX

APPENDIX

[EXCERPT]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. CP74-314

EL PASO NATURAL GAS COMPANY

STAFF'S COMMENTS TO COMPLAINT OF EL PASO NATURAL GAS COMPANY AND REQUEST FOR AN ORDER TO SHOW CAUSE

On June 3, 1974, El Paso Natural Gas Company (El Paso) filed with this Commission a complaint in which it alleges that certain persons are demanding increased payments for gas in violation of sections 4 and 7 of the Natural Gas Act. El Paso requests that the Commission (1) issue an order requiring those persons and others who may be affected to show cause why they should not be required to file rate schedules and obtain certificates of public convenience and necessity in accordance with Sections 4 and 7 of the Natural Gas Act; and (2) to schedule a hearing for the taking of testimony and for resolution of the issues presented by its complaint.

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The Sales Are Nonjurisdictional

Should the Commission decide that it should reach the question of whether these agreements relate to sales subject to its jurisdiction, Staff respectfully recommends that a finding of no jurisdiction can be made without the necessity of formal hearing proceedings. El Paso relies

upon the Supreme Court's decision in *Rayne Field*[9] for resolution of the issues in this case. The Court in *Rayne Field* held that sales to an interstate pipeline company of leases covering proven and substantially developed reserves of gas to be sold in interstate commerce were subject to the Commission's jurisdiction. In that case several companies had entered into gas purchase contracts to sell their natural gas production in Rayne Field, Louisiana to Texas Eastern, an interstate pipeline company. Upon learning that they would be required to justify the agreed upon price upon the ground of public convenience and necessity, the producers agreed upon a different method for the sale of the Rayne Field gas. The new proposal called for Texas Eastern to purchase the producer's leasehold interests in the Rayne Field lands in which the natural gas was located. The gas reserves were proven, the same volumes of gas were to flow as under the original gas sale proposal, 19 of a proposed total of 26 wells were already in the ground and one of the sellers was to continue to do the bulk of production work. The Court concluded that the provisions of the lease-sale agreements were such that they were in economic effect conventional sales of natural gas.[10] The objective of the original proposal was to transfer large amounts of natural gas to an interstate pipeline company for resale in other states. The parties, in setting forth the lease-sale proposal were not altering their objectives, but merely the method of obtaining them.[11]

The *Rayne Field* decision is not controlling here since what was transferred under El Paso's contracts was the right to explore for and produce gas. The El Paso contracts were not part of a scheme to avoid Commission

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[9] *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392 (1965).

[10] *Id.*, p. 396.

[11] *Id.*, p. 401.

regulation since many were entered into years before the Supreme Court decided *Phillips Petroleum Co.* v. *Wisconsin, et al.*,[12] which held producer sales for resale in interstate commerce subject to FPC regulation. Unlike *Rayne Field*, where the seller retained his role as producer, El Paso is the producer of gas found within these San Juan Basin leases. Where a lease-seller, such as Delhi-Taylor Oil Corporation (Delhi), agreed to drill wells upon the subject lands, they did so expressly as independent contractors who were to be compensated for such services based upon the price being charged generally for such work in the San Juan Basin. Although the agreements contain a minimum payment provision couched in terms of a take or pay clause, El Paso made the major decisions controlling development of the fields and upon a determination that a unit was not productive or was unprofitable El Paso either was to reassign such unit to Delhi or, in the case of an unprofitable unit, had the option of making such reassignment.[13] El Paso has consistently recognized their role as producer in these fields by classifying the expenditures involved with these leases as pipeline production in rate cases before this Commission. The fact that a board of arbitrators has raised payments from 10¢ to 40¢ per Mcf does not now transform these into payments made to producers for sales for resale in interstate commerce.

In *Rayne Field*, the Court was particularly influenced by the fact that the gas reserves were proven and that approximately 75 percent of the wells to be drilled on this land were drilled prior to the agreement.[14] This is in contrast to the factual situation presented by the very

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[12] 347 U.S. 672 (1954).

[13] Oil and Gas Lease Sale Agreement between El Paso Natural Gas Co. and Delhi Taylor Oil Corporation, dated January 18, 1952, (El Paso's Exh. A, p. 14)

[14] *Rayne Field*, p. 396.

contract El Paso uses to support its complaint in which only 6.25 percent [15] of the Delhi wells were drilled prior to the agreement and the contract provided for a vigorous exploration and development program.[16]

The interests retained are analogous to those which were before the Court of Appeals in *Mobil Oil Corp.* v. *F.P.C.* [17] in which the court stated:

> "While the lease by the landowner provides for a royalty in the event of the discovery and sale of gas, typically he has no control over any incident of such sale either as to quantity to be sold, the price to be paid, the identity of the purchaser or whether it shall be sold in interstate or intrastate commerce. To refer to the royalty owner as engaging in the sale is to depart from the common understanding of the words used, industry parlance, economic equivalent, or any other foundation hitherto considered a source for discerning congressional intention." [18]

Although the interest holders were conveying the right to explore, develop and produce to an interstate transporter when they sold their leases to El Paso, they had no control over any incident of sale, either, as to quantity, price, identity of purchaser or whether it would be sold in interstate or intrastate commerce. In *Mobil* the court addressed a factual situation similar to the current El Paso problem when it considered that payments to royalty owners may be in excess of applicable producer rates and that producers would then seek relief in the courts. The court stated:

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[15] Information set forth in Brief of Commission Staff and Petition to Reopen Proceedings To Complete The Record, Docket No. G-6887, *et al.*, filed June 29, 1970.

[16] El Paso/Delhi Agreement Article VI.

[17] 463 F.2d 256 (U.S. CADC, 1971).

[18] *Id.*, p. 262.

> "In any event we are not persuaded that the maintenance in either state or federal courts of contract (lease) controversies between royalty owners and lessees will undercut the federal regulatory system." [19]

The court then discussed various theories under which a court could reform the terms of a contract calling for royalty payments in excess of the producer ceiling and said:

> "The court handling the contract clause could avoid becoming embroiled in the ascertainment of the federal ceiling by referring that issue to the FPC . . . This would bring the FPC into the dispute between the royalty owner and the lessee-producer, but the FPC would be acting properly, on reference from the courts, rather than unduly stretching its jurisdiction and the statutory mandate to extend to royalty owners.[20]

By considering a factual situation in which contractual payments per Mcf of gas exceeded the producer ceiling, the court implicitly recognized that such a factual setting does not invoke this Commission's jurisdiction over royalty interest holders. Therefore, the fact that El Paso may now be required, under its contract, to pay 40¢ or more per Mcf of gas does not make the recipients of these payments subject to the jurisdiction of the Commission, although such payments will be reviewed for justness and reasonableness, pursuant to Section 4 of the Natural Gas Act, in El Paso's wholesale rate filings to this Commission. The producer rate ceiling will also be used as a guideline by the court reviewing the demands made by the interest holders under their respective contracts.[21]

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[19] *Id.*, p. 265.

[20] *Id.*, pp. 265-66.

[21] *Id.*, p. 265.

Conclusion

For the reasons stated above, Staff respectfully urges that the Commission deny the Complaint of El Paso Natural Gas Company and Request For An Order To Show Cause filed June 3, 1974.

Respectfully submitted,

/s/ Daniel P. Behuniak
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Commission Staff Counsel

Washington, D.C.
July 19, 1974

Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443 and 83-1618

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

NORTHWEST PIPELINE CORPORATION, *et al.*,
Petitioners,

v.

PHILLIPS PETROLEUM COMPANY, *et al.*,
Respondents.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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SUPPLEMENTAL MEMORANDUM OF THE PLA RESPONDENTS

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SUPPLEMENTAL MEMORANDUM OF THE PLA RESPONDENTS

The PLA respondents respectfully submit this Supplemental Memorandum [1] commenting upon the settlements and proposed settlements that have been entered into in the proceedings underlying the case before this Court.

As the PLA respondents noted in their Brief in Opposition of May 11, 1984, at page 26 & n.35, respondent Phillips Petroleum Company has entered into a final and complete settlement with petitioner Northwest Pipeline

[1] This Supplemental Memorandum is filed pursuant to the Court's letter of May 31, 1984, and Rule 22.6 of the Rules of this Court. A list of the PLA respondents and their corporate parents, subsidiaries and affiliates appears at pages ii to viii of the Brief in Opposition of the PLA Respondents.

Corporation. This settlement has already received the approval of the Federal Energy Regulatory Commission, which has terminated with prejudice the proceedings as to Phillips. Docket Nos. CP74-314, *et al.*, Order Approving Settlement Agreement (Nov. 23, 1983). The Northwest-Phillips settlement, which covers the majority of the PLA gas production, governs the determination of the overriding royalty with respect to production from and after October 1, 1982. In addition, Phillips has a contingent refund liability of $30 million,[2] payable only if this Court, or the Fifth Circuit, issues "a final, non-appealable order determining that the overriding royalties paid to Phillips under PLA-5 for the period September 25, 1980 to October 1, 1982, were subject to the regulatory jurisdiction of the Commission." Settlement Agreement ¶ VII. In the event this Court denies certiorari, or affirms the decision below, no refund is payable.

Getty Oil Company, another PLA respondent, has also entered into a final settlement with Northwest, on similar terms. If its lease-sale agreement is ultimately held to be jurisdictional, Getty would make a refund to Northwest of approximately $2 million; otherwise no refund is payable. The Northwest-Getty settlement has also received final Commission approval. Docket Nos. CP74-314, *et al.*, Order Approving Settlement Agreement (Mar. 30, 1984). Neither the Phillips settlement nor the Getty settlement was opposed by Northwest's customers or the relevant state commissions.

On May 18, 1984, subsequent to the filing of the Brief in Opposition of the PLA Respondents, petitioner El Paso Natural Gas Company and respondents Tenneco

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[2] This total is a fraction of the refunds initially sought. The Commission Staff estimated the potential refund liability of Phillips for the period February 1, 1974 to March 31, 1983, at $174 million. Docket Nos. CP74-314, *et al.*, Initial Comments of the Commission Staff on Offer of Settlement at 1 (June 9, 1983).

Oil Company and Conoco Inc. filed a proposed settlement with the Commission in these proceedings, which they characterized as "a full, fair, final and reasonable resolution of such proceedings as they affect El Paso, Tenneco Oil and Conoco." Docket Nos. CP74-314, *et al.*, Offer of Settlement and Joint Request for Approval of Stipulation of Settlement and Agreement at 1 (May 18, 1984). This proposed agreement, which is conditioned on Commission approval, would render this case moot as to a substantial portion of the natural gas production involved in these proceedings.[3] According to the Offer of Settlement, "Although relating to only four of eighteen GLA's at issue . . . , production attributable to these four GLA's constitutes approximately 70 percent of total production on all GLA's and approximately 15 percent of El Paso's total gas supply from the San Juan Basin. Thus, settlement by these parties will resolve as to the great majority of the gas involved . . . all issues as between El Paso, Tenneco Oil and Conoco . . . ." Offer of Settlement at 2. The Offer of Settlement further requests that the Commission direct the filing of a suggestion of mootness with this Court "at such time as the Commission's order approving the Settlement becomes final and no longer subject to judicial review." Offer of Settlement at 43-44.[4]

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[3] The PLA respondents agree with petitioner El Paso Natural Gas Company that this Court is not the appropriate forum in which to argue the merits or fairness of the proposed settlement. *See* Supplemental Memorandum of Petitioner El Paso Natural Gas Company With Respect to Settlements Between the Parties at 4 (June 8, 1974). That determination is plainly for the Commission to make in the first instance, and the question whether this settlement is in the public interest should not affect this Court's decision whether to grant or deny certiorari. The existence of the proposed settlement is nevertheless significant, because of the bearing it has on the continued vitality and potential impact of this controversy.

[4] Appendix B to the Supplemental Memorandum of Petitioner El Paso Natural Gas Company, filed June 8, 1984, similarly notes that "[a]fter Commission approval of the settlement by final order no

Under the proposed El Paso settlement with Tenneco and Conoco, the relationship among these parties is totally restructured. The properties covered by the Tenneco and Conoco GLAs are to be reconveyed by El Paso, with Tenneco and Conoco becoming conventional sellers of natural gas under 20-year gas sales contracts. Offer of Settlement at 15-16. In addition, the two respondent companies have a fixed refund liability of $50 million. Offer of Settlement at 24. Although the terms of the settlement are complex, and the PLA respondents have not had an opportunity to review them in detail, it appears that the payment of this $50 million refund is not contingent on the outcome of the case before this Court. Thus, although petitioners have contended that as much as $1 billion in refunds are at stake with respect to the GLA properties, *see* Joint Reply Brief in Support of Petitions for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit at 4, and have made the amount of money at issue a principal ground in support of certiorari, El Paso is apparently willing to compromise its claim with respect to approximately 70 percent of the GLA production for $50 million.

Taken together with the other settlements which have been approved to date, the proposed El Paso settlement with Tenneco and Conoco underscores the point made by the PLA respondents in Part II of their Brief in Opposition. These settlements make unmistakably clear that neither the financial viability of the pipelines, nor their ability to operate in the public interest, will be seriously affected by any ruling this Court makes. Since, as the PLA respondents demonstrated in their Brief in Opposition, the petitioners have presented no significant legal or public interest issue warranting this Court's attention,

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longer subject to judicial review, El Paso, Tenneco, and Conoco shall file with the Supreme Court a suggestion of mootness to reflect that a full and final settlement as between these parties has been reached." Supp. Mem. at 7a.

there is plainly no ground for the granting of certiorari in this case.

CONCLUSION

For the reasons stated here, and in their Brief in Opposition, the PLA respondents respectfully renew their request that the petitions for a writ of certiorari be denied.

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On Petitions For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

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QUESTION PRESENTED

Whether transfers of interests in essentially undeveloped natural gas leases to an interstate pipeline for exploration, development, and eventual production of gas for sale to the pipeline's customers, can constitute sales of gas within the jurisdiction of the Federal Energy Regulatory Commission, under Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b) (1982).

LIST OF PARTIES

The respondents adopt the list of parties in the Petition filed by the People of the State of California and the Public Utilities Commission of the State of California in No. 83-1321, at ii-vii. The respondent parties joining this brief are:

Union Oil Company of California ("Union")

Robert Beamon
Robert Beamon, Trustee
Pattie Ann Beamon Lundell
Thomas L. Hail, Trustee
(The "Beamon Parties")

W. Watson LaForce, Jr.
Henry P. Ishma, Jr. Estate
Robert T. Isham
Josephine C. Jacobson
J. Roberts Jones
Nancy LaForce Keyes
Frederic P. G. Lattner, Trustee,
U/T Martha M. Lattner, Settlor
Suzanne LaForce Baber
James C. Bard
Douglas N. Bard
Ralph A. Bard, Jr.
Roy E. Bard, Jr.
G. Brainard, Jr. Trust
Continental Illinois National Bank and
Trust Company, Trustee Trust #23935
Continental Illinois National Bank and
Trust Company, Trustee Trust #23949
Eleanor Isham Dunne
Charles W. Farnham, Jr.
Robert B. Farnham
Walter B. Farnham

Elizabeth B. Farrington
Minnie A. Fitting
R. U. Fitting, Jr. Estate
Robert D. Fitting
Nancy H. Gerson
John R. Grimes
Ruth N. Halls
Cortland T. Hill
Elsie F. Hill
Louis W. Hill, Jr.
Albert L. Hopkins, Jr.
George S. Isham
R.S. MacDonald, A. MacDonald and
Northern Trust Co., Trustees
U/W of N.S. MacDonald, Deceased
Mary F. Love
William J. McDermott, Trustee
Nora R. Ranney
Catherine H. Ruml
Edward L. Ryerson, Jr.
Sabine Royalty Corporation
Shaw, Isham & Company
John I. Shaw, et al., Trustee
James Simpson, Jr. Trust
William E. Simpson Trust
Sydney Stein, Jr.
Northern Trust Co., Trustee, U/W of John Stuart
Robert Douglas Stuart Estate
William P. Sutter
Michael Simpson Trust
Patricia Simpson Trust
Katharine I. White
Kay B. Gundlach
Frederick F. Webster Trust
Mary S. Zick

David Waller Dangler
(The "Lucerne Group")

SUBSIDIARIES (EXCEPT WHOLLY OWNED SUBSIDIARIES) AND AFFILIATES OF RESPONDENT UNION OIL COMPANY OF CALIFORNIA:

Kaneb Services, Inc.

Magma Power Co.

Unocal

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

Nos. 83-1321, 83-1432, 83-1433,
83-1442, 83-1443, 83-1618

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

On Petitions For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

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BRIEF OF UNION OIL COMPANY OF CALIFORNIA, THE BEAMON PARTIES AND THE LUCERNE GROUP IN OPPOSITION

Respondents Union Oil Company of California ("Union"), the Beamon Parties (Robert Beamon, Individually and as Trustee; Tom L. Hail, Trustee; and Pattie Ann Beamon Lundell), and the Lucerne Group (W. Watson LaForce, Jr. *et al.*) respectfully request that this Court deny the petitions for writ of certiorari, seeking review of the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

STATEMENT OF THE CASE

The petitions in this case[1] arise out of a series of lease sales that occurred during the early 1950's in the San Juan Basin area of northwestern New Mexico. The earliest of these were between El Paso Natural Gas Company ("El Paso") and certain predecessors of the various respondents; these were called Gas Lease Agreements or GLA's. Later but essentially similar transactions involved Pacific Northwest Pipeline Company and other respondents or their predecessors; these were called Pacific Lease Agreements or PLA's.[2]

Geology of the San Juan Basin

The numerous leases that were the subject of the 35 GLA's involved in this proceeding covered hundreds of thousands of acres in a general area of New Mexico referred to as the San Juan Basin. Consulting geologists retained by El Paso expressed great confidence that "large volumes of natural gas were available for extrac-

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[1] Petitions for Writ of Certiorari have been filed by the People of the State of California, *et al.* ("California") (No. 83-1321); the Public Utility Commissioner of Oregon, *et al.* ("Oregon") (No. 83-1432); Northwest Pipeline Corporation, *et al.* ("Northwest") (No. 83-1433); El Paso Natural Gas Company ("El Paso") (No. 83-1442); Pacific Gas and Electric Company, *et al.* ("PG&E") (No. 83-1443); and the Federal Energy Regulatory Commission ("FERC") (No. 83-1618). Citations to the various-petitions will be in the form "California Pet. at ____." The appendix prepared by California will be cited as "Pet. App. at ____."

[2] Union is a party to GLA's 76, 348, and 349. The Beamon Parties have interests under GLA's 77, 350, and 351. The Union GLA's apply to five-sixths, and the Beamon GLA's, one-sixth, of the working interest in substantially the same leases. The Lucerne Group is a party to GLA 66. This brief in opposition specifically addresses only the GLA transactions.

tion." Pet. App. at 53a. But it was obvious in the early 50's that the gas-bearing formations in the basin are "of varying depths and thicknesses," *id.* at 52a, and are "characterized by relatively low porosity and permeability," *id.* at 52a; *see also id.* at 9a, 127a. Since "[r]ecovery of natural gas from each productive formation is a function of the variations in the permeability and in the porosity of the formation," *id.* at 127a, and since the "Basin's geologic structure does not reveal those variations in any productive formation," *id.* at 127a-128a, the district court found that "geologic structure has little or no direct influence upon the localization of recoverable gas reserves," *id.* at 128a. For this reason the district court found, *id.*, and the court of appeals specifically affirmed, *id.* at 9a, that "*actual drilling is the only method of definitely locating recoverable gas saturations*" in the basin. (Emphasis added.)

Moreover, "[b]ecause the productive formations are tight, even where drilling located recoverable reserves, completed wells delivered gas in low volumes." *Id.* at 128a. In fact, the district court found that at the time the GLA's were executed, "[w]ells in the Basin generally were incapable of recovering commercially significant amounts of gas. . . . [T]hese wells [were] generally of such low deliverability that a producer could not hope to recoup his drilling costs. . . ." *Id.* at 132a. In short, only a regulated pipeline—which could include capital costs in its rate base and other drilling and operating costs in its cost of service, thus assuring that the slower the gas production the greater the aggregate return—could afford to develop these properties. *Id.* at 128a, n.13.

It was for these reasons that respondents' predecessors sold, and El Paso[3]—"in effect trading on its status as a utility regulated on the 'cost of service' basis," *id.* at 133a—purchased, the leases in question.[4] What was transferred pursuant to the GLA's were the leases or working interests—that is, the right to explore for, develop, and produce the gas reserves that were thought to underly the leases.[5] In exchange for that right, respondents' predecessors retained an overriding royalty, applicable only to the net working interest assigned, expressed in terms of cents per thousand cubic feet of gas

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[3] At the time most of the GLA's were executed, El Paso was the only interstate pipeline serving the basin. A second interstate pipeline was later constructed to the basin, and for a time a second customer for natural gas was available. However, El Paso soon purchased that pipeline in violation of the antitrust laws. *See* United States v. El Paso Natural Gas Pipeline Co., 376 U.S. 651 (1964).

[4] The GLA's here at issue were preceded by the so-called "Barker Dome transaction" (GLA-32) which most petitioners disingenuously advance as evidence of an intent to evade Commission jurisdiction, even though it is not involved in this proceeding. *See, e.g.*, El Paso Pet. at 4-6; FERC Pet. at 4-5. Both the district court and the Commission have rejected that theory, finding that the "parties did not enter into the GLA's [here at issue] as a means of shifting payments as in *Rayne Field* [United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392 (1965)]." Pet. App. at 133a; *and see* William G. Webb, 49 F.P.C. 17, 26 (1973). The district court explained that "the history of the Barker Dome agreement is not analogous to the agreements here at issue." Pet. App. at 125a, n.5. *Inter alia*, the Barker Dome agreement provided for an up-front payment tied to an estimate of reserves, whereas these GLA's did not. *Id.* at 127a & n.11.

[5] The first GLA's transferred only gas rights. But contrary to the Commission's assertion, FERC Pet. at 7, oil rights were also transferred by later GLA's. For example, GLA 348 transferred to El Paso Products Co. rights to all of the oil underlying that acreage.

produced from the acreage,[6] subject to escalation and redetermination at specified intervals.

Early Procedural History

For the next twenty years, the GLA's were consistently treated as nonjurisdictional lease sales (rather than sales of natural gas for resale in interstate commerce) by all parties, including the Federal Power Commission.[7] Thus, passthrough of the overriding royalties as an element of the cost of service of El Paso's own pipeline production was consistently sought by El Paso and regularly approved by the Commission—neither ever suggesting that the royalties were in fact payments for sales of gas. In *William G. Webb*, 49 F.P.C. 17 (1973), the Commission directly addressed the argument, made by its staff, that it "should regulate the transfer of the gas reserves here involved from the producers to El Paso in

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[6] The petitioners attempt to distinguish the form of the royalties here from those paid in the usual lease transaction. *See* FERC Pet. at 7, n.9; El Paso Pet. at 7-8. Those arguments fail to recognize the obvious: all royalties (including those here at issue) may be stated as a percentage of total production revenues. The fact that the so-called "special overriding royalty" was paid to the respondents based on the percentage interest they sold to El Paso (rather than on the totality of production) can have no significance. Similarly insignificant is the level at which the royalty is set. That a "base" royalty is frequently one-eighth (12 1½%), and the "special overriding" royalties here constitute a higher percentage has no legal or evidentiary significance. Royalties of all types—regular, overriding, or special overriding—can be found at all levels, high and low. To allow the level of the royalty to determine the Commission's jurisdiction would exalt form over substance.

[7] Both the Federal Power Commission and its successor the Federal Energy Regulatory Commission are referred to herein as "the Commission."

accordance with the *Rayne Field* case." *Id.* at 25. Agreeing with El Paso's position in that case, the Commission held that "the transactions should *not* be considered equivalent to the *Rayne* transactions because they arose under different circumstances." *Id.* at 26. The Commission thus rejected the staff's appeal that it hold these lease sales jurisdictional.[8]

Only when arbitration pursuant to the terms of the agreements resulted in the fixing of the royalty under one GLA at a level unacceptable to El Paso did that petitioner for the first time assert—in the suit that led to these petitions—that the lease sales were jurisdictional sales of gas. Following a seven-week trial, the United States District Court for the Western District of Texas found that "little if any actual drilling had been done on any acreage when its respective GLA was executed," and that "each GLA" was, therefore, "an agreement to transfer acreage which was not substantially developed." Pet. App. at 132a. The court next found that the "GLAs in issue were not transfers of leases with proven reserves . . . [b]ecause insufficient drilling had been done to prove up reserves in the specific acreage transferred. . . ." *Id.* at 131a. Finally, the court found that the GLA's "were not the economic equivalents of gas sales contracts," since "these agreements arose from the unique economic situation of the parties and reflected their efforts to structure the transactions so that El Paso would explore for and develop gas reserves in the Basin." *Id.* at 133a. On this basis the court held that "each agreement at issue in this

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[8] The owners of the interests adjudicated in *Webb* (respondents here) have consistently argued that the *Webb* holding of nonjurisdiction is *res judicata* as to them. Because of its decision on the principal issues, the court of appeals did not reach that question. Pet. App. at 19a.

litigation . . . is not a 'sale in interstate commerce of natural gas for resale' within the meaning of Section 5 of the Natural Gas Act of 1938.' " *Id.* at 134a-135a.

This conclusion was particularly appropriate in the context of the Union, Beamon and Lucerne GLA's. On the 26,687.41 acres covered by GLA 76, for example, only four wells had been drilled at the time the agreement was signed. On GLA 348, transferring deeper rights to the same acreage, only two wells were in existence at execution. Pet. App. at 66a-67a. GLA's 77 and 350 applied to one-sixth of the working interest in leases on substantially the same lands. *Id.* Lucerne's GLA 66 had no wells on 2,480 acres at execution. *Id.* The GLA's thus allocated to El Paso the burdens and risks of exploring, developing and producing the acreage, retaining for the predecessors of Union, the Beamon Parties, and Lucerne only the right to receive an overriding royalty on El Paso's production.[9]

Court Of Appeals Decision

El Paso appealed the district court decision to the Fifth Circuit. While that appeal was pending, the Commission instituted a proceeding to reconsider the jurisdictionality

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[9] Contrary to El Paso's assertion, Union did not "voluntarily accept . . . reassignment" of its GLA leases. *See* El Paso Pet. at 10, n.12. Union agreed to accept reassignment of GLA's 76, 348, and 349, effective October 1, 1983, only in settlement of a state court lawsuit brought by El Paso. *See* El Paso Natural Gas Co. v. Tenneco Oil Co., *et al.*, No. 83-50539 (Dist.Ct. of Harris County, 11th Judicial Dist. of Texas, Feb. 27, 1984). The settlement leaves the jurisdictional question unresolved for periods prior to October 1, 1983. The Beamon Parties and the Lucerne Group have rejected El Paso's purported reassignments, and the state court litigation confirmed their right to do so.

of the GLA's. Relying on the stipulated district court record—supplemented by some new evidence principally concerning agreements not litigated in the district court—the Commission on September 25, 1980 reversed its three-decade-old position and held that the GLA's are subject to its jurisdiction. Pet. App. at 21a. Petitions for review of the Commission decision were consolidated with the pending appeal from the district court holding, and the court of appeals addressed both together.

The court of appeals held that the GLA's are not sales of gas as defined by the Natural Gas Act, 15 U.S.C. §§ 717-717z (1982) ("NGA"). Pet. App. at 5a. It looked to the three-pronged test of *Continental Oil Co.* v. *Federal Power Commission*, 370 F.2d 57 (5th Cir. 1966), *cert. denied* 388 U.S. 910 (1967) ("*Ship Shoal*"), derived from this Court's opinion in *Rayne Field*.[10] Noting that a lease sale transaction is not jurisdictonal "[u]nless all the *Rayne Field* factors . . . are satisfied," Pet. App. at 14a-15a, the court focused on one prong of the *Ship Shoal/ Rayne Field* test: substantial development. A unanimous panel specifically held that the "reserves underlying the leaseholds were not substantially developed at the time the lease sales were executed because of the lack of 'imminent ability to produce in commercial quantities.' " *Id.* at 15a (quoting *Ship Shoal*, 370 F.2d at 64). Explaining this holding, the court acknowledged that "[a]n important factor" was "the limited extent to which the Basin had

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[10] The test is comprised of three questions:

"(1) Is the economic effect of the transfer similar to that of a conventional sale?

"(2) Is the subject of the transaction 'proven and substantially developed' reserves?

"(3) Is the transfer of the reserves for purpose of interstate transmission and resale?" 370 F.2d at 62.

been drilled at the time the GLAs and PLAs were executed." *Id.* at 15a. It noted that "the few wells in the ground when the agreements were executed could not have come close to depleting the acreage," *id.* at 16a, and pointed out that both the Commission and the courts have considered the number of wells existing at execution (in comparison to the number needed to complete production) a relevant factor, *id.* at 16a-17a (citing *Texas Gas Transmission Corp.*, 3 FERC (CCH) ¶ 61,135 (1978), and *Rayne Field*, 381 U.S. at 396 and n.3, 403 and n.8).

Because of its holding that the GLA's were not substantially developed, the court of appeals had no occasion to address the district court's finding that the GLA's did not transfer proven reserves[11] and were not the economic equivalents of gas sales. Thus, the only questions before this Court are whether substantial development should continue to be a requirement of the *Rayne Field* test, and if so, whether the court of appeals erred in holding that the GLA's were not substantially developed. If the judgment below is reversed, however, the court of appeals will still have to consider the correctness of the district court's holdings that the GLA's did not transfer proven reserves and were not the economic equivalent of sales of gas. It will also have to decide other difficult questions, such as the *res judicata* and collateral estoppel issues flowing from the *Webb* case and the district court decision.

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[11] The court of appeals suggested in passing that "the reserves *in the Basin* may well have been 'proven' at least within reasonable estimates." Pet. App. at 15a (emphasis added). However, the Court did not purport to analyze that issue and certainly did not pass on the district court's finding that the existing reserve estimates covered the Basin as a whole and could not be related to *specific leases* without substantial further drilling. *See Id.* at 131a.

REASONS FOR DENYING THE WRIT

I. Review Of The Judgment Below Is Not Required To Protect The Public Interest

A. The Court of Appeals judgment has no prospective effect on gas consumers

A decision to reverse the decision below would have no prospective impact on natural gas consumers. A jurisdictional holding would require that the GLA gas be priced at or below Natural Gas Policy Act, 15 U.S.C. §§ 3301-3432 (1982) ("NGPA"), ceilings. But, as the Commission concedes in its petition, from the effective date of the NGPA (December 1, 1978), "[i]f the lease transactions are deemed to be non-jurisdictional . . . the pipelines [can] charge their customers only the applicable NGPA rate rather than the cost-of-service rate." FERC Pet. at 21. In other words, El Paso and other pipelines are now required to price their post-NGPA production at or below the applicable NGPA rate, regardless of the amount they pay in special overriding royalties or other production costs. This requirement stems from the decision of this Court in *Public Service Commission of New York* v. *Mid-Louisiana Gas Co.*, 463 U.S. ____, 103 S.Ct. 3024, 77 L.Ed.2d 668 (1983) ("*Mid-La*"). Accordingly, whether it is reversed or not, the judgment below will not affect what consumers pay for gas from and after the effective date of the NGPA.

To be sure, the Commission is empowered to increase the price that can be charged by El Paso so as to cover the costs resulting from its payment of the special overriding royalties. *See* NGPA § 104(b)(2), 15 U.S.C. 3314(b)(2) (1982); *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co.*, 439 U.S. 508 (1979). But the responsibility of the Commission is to watch out for the

overall benefit of consumers.[12] The Commission could not, therefore, restrict its analysis of a request for higher rate to the particular leases at issue here. Rather, it would be required to take a comprehensive look at the impact of all current developments in gas pricing before granting such extraordinary relief to El Paso. Thus, it is significant that El Paso will receive a considerable windfall (as much as $20 million in 1983, $30 million in 1984, and more thereafter)[13] from the application of the *Mid-La* decision to pipeline production not here at issue. Payment of the special overriding royalties out of El Paso's own pocket would, at most, reduce slightly the extent of that windfall. In any event, no price in excess of the NGPA ceiling may be charged without prior Commission approval based on its independent assessment of what constitutes a just and reasonable rate.

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[12] The Natural Gas Act does not require the Commission to make price adjustments merely to prevent a producer (such as El Paso) from losing a portion of its profits due to royalty increases. *See* Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., 439 U.S. 508, 517 (1979); *accord*, Cities Service Gas Co. v. Federal Power Comm'n, 424 F.2d 411 (10th Cir. 1969).

[13] These amounts are estimates transmitted orally to the Commission by El Paso. Letter from Charles A. McManus (Director, FERC Office of Congressional, Intergovernmental and Public Affairs) to Rep. Phillip R. Sharp (Chairman, Subcommittee on Fossil and Synthetic Fuels, U.S. House of Rep.) (Aug. 8, 1983). An exhibit in evidence in El Paso Natural Gas Co. v. Tenneco Oil Co., et al., No. 83-50539 (Dist. Ct. of Harris County, 11th Judicial Dist. of Texas, Feb. 27, 1984) contains an in-house El Paso estimate that revenues over the next twenty years will, because of *Mid-La*, be $4.6 billion more than they would otherwise have been.

B. Reversal of the Court of Appeals judgment is unlikely to benefit consumers retroactively.

Most petitioners emphasize the enormous refunds that would allegedly flow to consumers from a reversal of the court of appeals judgment. *See, e.g.*, FERC Pet. at 20-21; El Paso Pet. at 9, n.8; PG&E Pet. at 13-14. That argument is little more than a pipe dream.

First, as noted above a reversal of the instant court of appeals judgment would only require that court to review the other grounds for the district court's holding (inability to particularize proved reserves for individual leases and lack of economic equivalency). Even if the district court findings were overturned on those issues, the court of appeals would still be required to resolve thorny problems of *res judicata* and collateral estoppel, as even El Paso admits. *See* El Paso Pet. at 25; Pet. App. at 19a. Only if all of these issues were resolved in favor of El Paso would there be any predicate for the refunds sought by the pipeline.

Second, the Commission proceeding to determine whether refunds should be ordered, and if so in what amounts, had not yet even reached the hearing stage when it was suspended as a result of the court of appeals decision. However, Union and other respondents had submitted testimony in that proceeding suggesting that they had in fact been *underpaid* rather than overpaid by El Paso for the GLA gas during past periods. In short, El Paso's refund claim is at this point nothing more than a litigation position which remains to be tested.

Third and most important, even if there have been overcharges resulting from the parties' treatment of the GLA's as nonjurisdictional, the Commission's authority under the NGA to order refunds is far from unfettered; such extraordinary relief can only be granted where the

equities warrant it. *See, e.g., Laclede Gas Co.* v. *FERC*, 670 F.2d 38, 42 (5th Cir. 1982). The Commission has recognized that the absence of notice that a sale was jurisdictional is of particular concern in the weighing of factors for and against refunds. *See, e.g., Delta Gas, Inc.*, 43 F.P.C. 620, 623 (1970); *Hugoton Production Co.*, 41 F.P.C. 490, 497 (1969). An administrative agency may abuse its discretion by changing its position on a jurisdictional issue, and then imposing retroactive liability for failure to foresee that change. Like other administrative agencies, the Commission "may not render jurisdictional decisions, overrule them *retroactively* and thereby transform [a producer's] interim behavior, legal when pursued, into illegal [acts]." *Transportation Enterprises, Inc.* v. *National Labor Relations Board*, 630 F.2d 421, 424 (5th Cir. 1980) (emphasis in original).[14]

In short, the Commission's September 25, 1980 decision to assert jurisdiction over the GLA's was a radical departure from a three-decade-old position. Given its

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[14] The situation addressed by the Fifth Circuit in *Transportation Enterprises* was remarkably similar to that which would face any court hearing a request for retroactive application of the jurisdictional ruling pronounced by the Commission in this case. The N.L.R.B. had, through its regional office, ruled that a particular enterprise was outside its jurisdiction—just as here the Commission ruled in *William G. Webb* that some of the GLA's were outside of its jurisdiction. Years later, pursuant to an appeal from a subsequent ruling, the Board reversed its earlier jurisdictional ruling—just as here the commission has reversed *Webb* some years later in response to a subsequent petition by El Paso. The court in *Transportation Enterprises* ruled that the company was subject to the Board's jurisdiction from the date of the new jurisdictional decision. But prior to that decision, the company "had the right to rely on the decision . . . that it was not subject to the jurisdiction of the NLRB." 630 F.2d at 424. The respondents here had a similar right to rely on the Commission's decisions in *Webb* and in various El Paso rate cases, as well as on the district court's 1977 non-jurisdictional holding.

history of treating these transactions as non-jurisdictional, it would be simply impermissible for the Commission to impose refund liability retroactively for the period during which the parties—including all of the petitioners—treated the transactions as non-jurisdictional, even if El Paso ultimately prevails on the jurisdictional issue *and* proves overcharges.

C. The private dispute between El Paso and the respondents does not merit Supreme Court review.

Given the *sui generis* nature of the GLA transactions, the lack of impact that the court of appeals judgment can have on future gas prices, the retention by the Commission of authority fully to protect consumer interests, and the unlikelihood of refunds relating to past periods, the only remaining dimension of this case is the private contractual dispute between El Paso and the respondents. That dispute has already been the subject of a decade of negotiations, arbitration, and litigation; there is no need further to prolong its final resolution. To the extent that El Paso is unable to recover all of its costs of producing natural gas from the GLA leases, it merely suffers the consequences of its own decision to enter into the GLA's.

Moreover, the discussion of the impact of the judgment below on El Paso must occur in the context of the post-*Mid-La* world. El Paso stands to gain $4.6 billion from its newly-acquired ability to charge NGPA rather than cost-of-service rates to its customers.[15] To the extent that El Paso's operation of the GLA properties is in fact unprofitable,[16] its windfall is merely reduced somewhat.

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[15] *See* n. 13, *supra*, and accompanying text.

[16] El Paso has been unable to establish this proposition in litigation brought in Texas state court. El Paso Natural Gas Co. v. Tenneco Oil Co., *et al.*, No. 83-50539 (Dist.Ct. of Harris County, 11th Judicial Dist. of Texas, Feb. 27, 1984). At the very least, the decision of the

The possible reduction of the amount of that windfall due to a private contractual relationship between El Paso and the respondents provides no basis for this Court to hear the instant case.

II. The Decision Of The Court Of Appeals Is Correct On The Merits.

A. The decisions of this Court properly require substantial development as a prerequisite for Commission jurisdiction over lease sales.

The petitioners point out, quite correctly, that the Commission has jurisdiction "over the rates of all wholesales of natural gas in interstate commerce." *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682 (1954). But that statement, oft paraphrased in the petitions, is beside the point; the question before the Fifth Circuit (and the question for which the writ is requested) was whether these sales of leases in fact constituted wholesales of natural gas. As the Commission put it, "the dispositive question is whether what was sold was gas or merely the right to explore for gas." FERC Pet. at 19.

Addressing that question, this Court established in *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949) *("Panhandle")*, that sales of undeveloped natural gas leases are not covered by the NGA. However much petitioners dislike that decision, it has not been overturned. Even in *Rayne Field* this Court continued to recognize that sales of "the particular kind of leases that were before the court" in *Panhandle*, are outside the jurisdiction of the Commission. 381 U.S. at

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Texas court makes clear that mere assertions that El Paso will lose money on its production from the GLA properties cannot be accepted at face value.

404. The Court reached a different result in evaluating the *Rayne Field* lease sales only because it noted

> "[t]wo distinctions . . . . *First*, the *Panhandle* leases were undeveloped. The Rayne Field leaseholds were substantially developed. . . . *Second*, *Panhandle* did not involve a sale of natural gas for resale in interstate commerce, but a transfer by an interstate transmission company to a production company for sale of the gas in *intra*state commerce." 381 U.S. at 403-04 (footnote omitted) (emphasis in original).

There can be no question that the substantiality of development is a separate and appropriate criterion for determining jurisdictionality. The fact that this Court in *Rayne Field* distinguished *Panhandle* "first" on the basis that the "*Panhandle* leases were undeveloped," *id.* at 403, makes clear that the Court viewed substantial development as an issue separate and apart from whether the acreage was proven. Any doubt on this score was resolved by the Court's explanation:

> "The substantially of development is a relevant consideration, for the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce which, as *Phillips* held, the Act has affirmatively placed within Commission jurisdiction." *Id.*

The court of appeals "perceive[d]" that this Court's concern with substantial development reflects its "concern with the apparent congressional intent not to regulate production." Pet. App. at 15a. This Court has held that the "production or gathering" exemption *see* NGA § 1(b), 15 U.S.C. § 717(b) (1982) "relates to the physical activities, processes and facilities of production or gathering, but not to sales of the kind affirmatively subjected to Commission jurisdiction." *Rayne Field*, 381 U.S. at 402.

The very essence of the "physical activities, processes and facilities of production" is the drilling of wells, the placement of casing, the erection of platforms, and the like.

The close identification of the drilling function with production or gathering is the key to understanding the relationship identified in *Rayne Field* between substantial development and economic equivalency. The *sine qua non* of a gas sale is that the seller has borne the risks[17] and expenses of drilling the well from which gas is produced. If those risks and expenses are transferred to the buyer—as they are in a sale of undeveloped leases—then the lease sale simply cannot be economically equivalent to the sale of gas.[18] For that reason, the court of appeals implicitly concluded that the lack of substantial development, and the consequent placement of the risks and burdens of drilling on the pipeline purchaser of the leases, made the GLA's quite different from jurisdictional sales

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[17] The risks here were substantial. Both the district court and the court of appeals specifically found that "actual drilling is the only method of definitely locating recoverable gas saturations" on the GLA's. Pet. App. at 9a; *see id.* at 128a.

[18] Both El Paso and the Commission noted that, even under a traditional gas sales contract, the producer ordinarily does not fully develop the property until he has obtained sales commitments for the gas. El Paso Pet. at 6, n.3; FERC Pet. at 17, n.15. That answer misses the point. Even if he waits until he has a sales contract in hand, it is still the producer who bears the risk and expense of drilling under such a contract. However, if a lease owner transfers his undeveloped lease, then the risk and expense of drilling are on the purchaser, and the transaction is not economically equivalent to a gas sale. That is what the district court meant when it found that "[t]he structuring of the economic risks and benefits between the parties more closely resembles the reallocation of risks and benefits in a farm-out than in a gas sales contract." Pet. App. 133a.

of gas. That decision is squarely—and properly—required by the opinions of this Court.

B. Substantiality of development is appropriately measured by the number of wells drilled.

Petitioners assert, however, that even if substantial development is a proper test, the court of appeals erred in counting wells and comparing the number of wells drilled with available drilling spaces. *See, e.g.*, FERC Pet. at 18-19. Elsewhere, however, the Commission has espoused the very approach it condemns here.

In *Texas Gas Transmission Corp.*, 3 FERC (CCH) ¶ 61,135 (1978), for example, the Commission looked carefully at the development of the leases prior to finding that their sale was not a jurisdictional sale of gas. The Commission noted that considerable development had taken place prior to the sale; fourteen wells had been completed, ten were already producing, and additional wells had been started. The Commission observed, however, that plans were "under way to complete 50 wells that had been started and abandoned [by the seller] and to start an additional 50 new wells." *Id.* at p. 61,405. It therefore concluded that the sellers "had not sufficiently developed the field to be able to conduct economically feasible wellhead arrangements." Thus, the Commission in *Texas Gas Transmission* made a jurisdictional decision by looking at the extent of development, and comparing the drilling completed with that required for full development.

Even more illuminating is the Commission's practice in administering the incentive price provision in section 107(c)(5) of the NGPA, 15 U.S.C. § 3317(c)(5) 1983), as it relates to "tight formations." In that context the Commission has developed the practice of excluding areas that were "substantially developed" prior to the issuance of an

infill drilling order, provided certain other factors are also present. In determining which areas are substantially developed, the Commission counts wells—that is, it looks to the "total number of developed [drilling] units . . . divided by the total number of available [drilling] units." Order No. 220, FPC Docket RM79-76 (April 2, 1982), 47 Fed. Reg. 15316 (1982). Significantly, the Commission has held that 41% development "does not . . . [constitute] substantial development." *Id.* at 15317. None of the significant GLA's here at issue even approached 41% development as of the date of execution.[19]

C. The decision below is consistent with *Ship Shoal*.

All of the petitioners insist that the decision of the court below conflicts with *Ship Shoal*, an earlier decision by another panel of the same court. But a careful comparison of the two decisions belies that assertion.

As a matter of law, in deciding the case at bar the court below applied precisely the same three-pronged test it had formulated in *Ship Shoal*. Pet. App. at 12a. If the assertion is that the court below applied its own *Ship Shoal* test improperly, it is the responsibility of the Court of Appeals for the Fifth Circuit and not the responsibility of this Court to resolve that issue.[20] A conflict between

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[19] For example, based on 160 acre spacing, the four Pictured Cliffs wells completed on GLA's 76 and 77 as of the date of execution constituted approximately 2% development. *See* Pet. App. at 66a. The Mesa Verde formation underlying GLA 76 was *undrilled* at the date of execution. *Id.* By May 1, 1975, there were 167 wells in the Pictured Cliffs and 63 wells in the Mesa Verde formation. *See* Joint Appendix at 232a-233a, El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (5th Cir. 1983).

[20] The appeals court's summary denial of petitioners' suggestions for rehearing *en banc*, without a single dissenting vote, suggests that the Fifth Circuit itself saw no conflict with *Ship Shoal*. Pet. App. at 152a.

panels of the same court does not generally present a question for which certiorari will be granted. *See Davis* v. *United States*, 417 U.S. 333, 340 (1974); *Wisniewski* v. *United States*, 353 U.S. 901 (1957) *(per curiam)*.[21]

In any event, however, the court of appeals had ample factual basis on which to distinguish this case from *Ship Shoal*. In *Ship Shoal*, twelve wells had been drilled on 3,000 acres, with multiple completions, prior to the sale.[22] That is the equivalent of one well for each *250 acres*. Here the situation was vastly different. Development prior to execution of the GLA's[23] had been extremely limited. The

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[21] Mr. Justice Harlan has noted that "contrary decisions between different panels of the same Court of Appeals will not be considered to present a reviewable conflict, since such differences of view are deemed an intramural matter to be resolved by the Court of Appeals itself." Harlan, *Manning the Dikes*, 13 Rec. A.B. City N.Y. 541, 552 (1958).

[22] As the presiding examiner noted in his initial decision:

> "The CATC producers before May 10, 1961 had erected three drilling platforms at Ship Shoal and had drilled about 12 wells, with multiple completions, therefrom. Costs to the producers do not appear, but depreciable property of the producers at Ship Shoal seems to have been $2,280,000. . . . Substantial quantitites of gas and oil were found. The gas was shut in, and has remained unconnected to date. Some of the oil was produced, and was barged to shore from storage tanks on the platforms." *Tennessee Gas Transmission Co.*, 30 F.P.C. 759, 799 (1963).

[23] The Commission assails the court's use of the date of execution as the time to measure development. FERC Pet. at 17, n.15. But petitioner fails even to acknowledge "the controlling authorities"—*Rayne Field* and *Ship Shoal*—on which the court based its conclusion that "jurisdiction must be evaluated at the time lease-sale agreements are executed." Id. at 17a. The reason for that conclusion is apparent: Upon execution, the parties are bound to their agreement; the actual transfer of title that occurs at closing is but a ministerial act required by the prior agreement. The jurisdictionality of the deal must be determined when the parties become bound to it.

court cited "dramatic example[s] of the lack of substantial development." Pet. App. at 16a. Union's GLA 348 is such an example; it had only two wells on over 26,000 acres—less than one for each 13,000 acres. Pet. App. at 66a-67a. Not only could the court fairly conclude that "the acreage was far less drilled than the land covered by the agreements found jurisdictional in *Rayne Field*," *id.* at 15a, it was also compelled to conclude that development had not reached the point that had been reached in the *Ship Shoal* case.

D. The *Louisiana Land*, *Mobil*, and *Cities Service* decisions demonstrate the propriety of the decision below.

Various of the petitions also suggest that the decision below conflicts with three other court of appeals decisions: *Louisiana Land and Exploration Co.* v. *Federal Energy Regulatory Commission*, 574 F.2d 204 (5th Cir. 1978), *cert. denied*, 439 U.S. 1127 (1979) *("Louisiana Land"); Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972) *("Mobil");* and *Cities Service Gas Co.* v. *Federal Power Commission*, 424 F.2d 411 (10th Cir. 1969), *cert. dismissed*, 400 U.S. 801 (1979) *("Cities Service")*. On the contrary, these cases in fact support the conclusions of the court below.

The most recent of the three cases, *Louisiana Land*, was decided by a panel that included two of the judges who heard the appeal in the instant case.[24] The panel recognized, as the Commission had found, that the *Louisiana Land* "transaction was closely connected with [a] lease-sale transaction." *Delta Development Co.*, 56 F.P.C. 922, 925 (1976). *See* 574 F.2d at 206-07. But the

[24] Circuit Judges Brown and Roney were joined by Judge Godbold in *Louisiana Land*, and by Judge Tjoflat in this case.

jurisdictional question addressed by both the Commission and the court of appeals in *Louisiana Land* had to do with an "agreement [that] arose from separate negotiations." 56 F.P.C. at 925. Evaluating that separate transaction, the court of appeals declined to apply its three-pronged *Ship Shoal* test because, as the court accurately noted, Louisiana Land and Exploration "did not sell a lease in a transaction that mirrors those in *Rayne Field* and *Ship Shoal*." 574 F.2d at 207. Instead the court distilled the essence of the *Ship Shoal* analysis: a determination of jurisdictionality must not "ignore . . . economic realities." *Id.* Application of that general principle led the panel to conclude that the *Louisiana Land* transactions were jurisdictional, while the clearly compatible *Ship Shoal* test itself later compelled an opposite conclusion in the case of the GLA lease sales.

Similarly consistent with the result and rationale below is the decision of the Court of Appeals for the D.C. Circuit in *Mobil*. The court there rejected an attempt by the Commission to extend its jurisdiction to cover royalty provisions of oil and gas leases. The *Mobil* court evaluated the " 'significant and determinative economic facts'," as required by *Rayne Field*. 463 F.2d at 262. It therefore recognized the basic economic difference between oil and gas leases, which transfer only the right to explore, develop, and market (if exploration and development are successful), and sales of oil and gas produced from such leases, *id.* at 262-63, much as the court below recognized the differences between sales of undeveloped leases and the sale of gas-in-place by transfer of proved and developed leases.[25]

[25] Significantly, the *Mobil* court noted that exclusion of royalty arrangements from the Commission's jurisdiction would not prevent the Commission from achieving its purposes—*i.e.*, "to protect the

In *Cities Service*, the Tenth Circuit did not even address the question of jurisdiction. Rather, recognizing its lack of "jurisdiction over security transactions relating to natural gas companies," 424 F.2d at 417, the Commission proceeded to consider "the proper allowance in [Cities Service] Gas Co.'s cost of service for gas from production properties it previously owned," *Continental Oil Co.*, 39 F.P.C. 1034, 1047 (1968). The court of appeals held that the Commission's lack of jurisdiction over the transfer did "not foreclose the FPC from fixing appropriate rates under the Act," 424 F.2d at 417, and affirmed a Commission order requiring Cities to pay more for gas than it was authorized to charge, *id.* at 415. Thus, the Tenth Circuit upheld precisely what El Paso and the Commission complain about here.

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ultimate beneficiaries [of the NGA] against exploitation by natural gas companies." *Id.* at 263. "[T]he FPC's jurisdiction over rates chargeable by a producer includes authority to determine the reasonableness of costs incurred, even though these are not subject to direct FPC control. . . ." *Id.*

CONCLUSION

The petitions for writ of certiorari should be denied.

Respectfully submitted,

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Nos. 83-1321, 83-1432, 83-1433
83-1442, 83-1443, 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

On Petitions For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

SUPPLEMENTAL MEMORANDUM OF UNION OIL CO. OF CALIFORNIA

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**On Petitions For A Writ Of Certiorari
To The United States Court Of Appeals
For The Fifth Circuit**

SUPPLEMENTAL MEMORANDUM OF UNION OIL CO. OF CALIFORNIA

Respondent Union Oil Company of California ("Union") files this Supplemental Memorandum pursuant to the invitation of the Court, as evidenced by the Clerk's letter of May 31, 1984. Although Union will leave it to the parties to that settlement to discuss the offer of settlement and agreement filed with the Federal Energy Regulatory Commission ("FERC") on May 18, 1984,[1] it de-

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[1] Union cannot help noting, however, the stark inconsistency between the statement on p.3 of the Supplemental Memorandum of Petitioner El Paso Natural Gas Company ("EP. Supp. Mem.") ("[n]either settlement renders the matters before the Court moot, in whole or in part") and point G of the summary of the El Paso-Tenneco-Conoco settlement, which provides that the parties "shall file with the Supreme Court a suggestion of mootness to reflect that a full and final settlement between the parties has been reached" (EP. Supp. Mem. at 7a).

scribes and discusses below its own settlement, entered into on November 11, 1983.[2]

As noted in Union's Brief in Opposition, p. 7, n.9, the November 11, 1983 settlement between Union and El Paso Natural Gas Co. ("El Paso") does not purport to affect periods prior to its effective date. It therefore leaves the jurisdictional question raised by the petitions, and the issue of potential refunds, unresolved for the retroactive period.

Union agreed to accept reassignment of the leases covered by GLA's 76, 348, and 349, upon receipt from the FERC of a satisfactory certificate under Section 7(c) of the Natural Gas Act, 15 U.S.C. § 717f(c) (1982) ("NGA"), and acceptance by the FERC of the gas purchase contract negotiated between Union and El Paso as Union's initial rate schedule under Section 4 of the NGA. Pursuant to that agreement, Union filed, on December 13, 1983, an application with the FERC for a certificate of public convenience and necessity authorizing it to sell gas from the GLA leases to El Paso. That application remains pending in Docket No. CI84-141-000.

Contrary to the assertion at EP.Supp. Me. 5, the questions before the FERC in Docket CI84-141-000 do not depend on the outcome of the jurisdictional issue presented in the petitions. Only in El Paso's convoluted world—where GLA transactions that have been uniformly treated and defended as nonjurisdictional for twenty years suddenly become jurisdictional when it suits El

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[2] The parties are currently discussing certain proposed changes in the Union settlement; however, none of the changes presently under consideration would affect the general principles of the settlement set out below.

Paso's business needs—can its agreements to *settle* these cases be viewed as *supporting* its petition for review by this Court.

The Union settlement, if it becomes effective, would eliminate, as to Union, the jurisdictional issue presented by the petitions for periods after its effective date. To that extent, therefore, it would also eliminate any public interest in review of the jurisdictional question.

Respectfully submitted,

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Respondents

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF RESPONDENTS, WILLIAM G. WEBB, *et al.*, IN OPPOSITION

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May 11, 1984

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QUESTION PRESENTED

Whether the opinion below has any prospective effect in view of Congress' determination through passage of the Natural Gas Policy Act, 15 U.S.C. § 3301 *et seq.*, to exempt from the Federal Energy Regulatory Commission's jurisdiction under the Natural Gas Act, 15 U.S.C. § 717 *et seq.*, natural gas that was not already dedicated under such statute prior to November 8, 1978.

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On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF OF RESPONDENTS, WILLIAM G. WEBB, *et al.*, IN OPPOSITION

As respondents, William G. Webb, *et al.*, (Webb)[1] oppose the petitions for a writ of certiorari to the United

[1] This brief in opposition is filed on behalf of the following respondents:

William G. Webb, Estate of J. Glenn Turner, Benson-Montin-Greer Drilling Corporation, B & M Construction Corporation, Earl A. Benson, *et al.*, Edna Fern Benson, Oliver Benson, Walter Benson, Barbara Ann Bruss, Albert Greer, Charlene

States Court of Appeals for the Fifth Circuit filed by The People of the State of California, *et al.* (California) in No. 83-1321; The Public Utility Commission of Oregon, *et al.* (Oregon) in No. 83-1432; Northwest Pipeline Corporation, *et al.* (Northwest) in No. 83-1433; El Paso Natural Gas Company (El Paso) in No. 83-1442; Pacific Gas and Electric Company, *et al.* (Pacific) in No. 83-1443; and the Federal Energy Regulatory Commission (Commission) in No. 83-1618.[2]

STATUTES INVOLVED

Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b), provides:

> The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transporta-

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Greer, Charles Albert Greer, La Plata Gathering System, Inc., Jack London, Jr., O. J. Lilly, Barbara Irene McConnell, A. C. Montin, Jr., William V. Montin, Estate of C. W. Murchison, Oklahoma and Northwestern Company, Frank A. Schultz, Sue Reeder Turner Trust, Jaqulyn Williams.

In Opinion No. 642, 49 F.P.C. 17 (1973), the Federal Power Commission (now the Federal Energy Regulatory Commission) held the lease-sale transactions of these Webb parties to be non-jurisdictional, *i.e.*, not subject to the Commission's jurisdiction under the Natural Gas Act. The order of the Commission now under review purports to hold that these same lease-sale transactions, as well as other, different lease-sale transactions involving other parties, are jurisdictional. The Webb parties do not waive and specifically reserve their rights under the doctrines of collateral estoppel and *res judicata* which they raised below, but which the court below did not address. 708 F.2d 1011 at 1020 (App. 1a at 19a).

[2] Pursuant to Rules 22 and 34.2, Webb adopts the portions of the Petition filed by California in response to Rule 21.1(b), (d), and (e). The Appendix (App.) references in this brief are to the appendix volume filed by California with its petition in No. 83-1321.

tion or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Section 601(a)(1)(A) of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3431(a)(1)(A), provides:

Sec. 601. Coordination with the Natural Gas Act.

(a) Jurisdiction of the Commission Under the Natural Gas Act—

(1) Sales—

(A) Natural Gas Not Committed or Dedicated.—For purposes of section 1(b) of the Natural Gas Act, effective on the first day of the first month beginning after the date of the enactment of this Act, the provisions of the Natural Gas Act and the jurisdiction of the Commission under such Act shall not apply to natural gas which was not committed or dedicated to interstate commerce as of the day before the date of enactment of this Act solely by reason of any first sale of such natural gas.

REASONS FOR DENYING THE WRIT

Aside from the fact that the decision of the Fifth Circuit is correct on both the law and the facts of this case, the argument advanced by the petitioners as to why this Court should grant certiorari does not exist. The petitioners' common theme is that the decision of the Fifth Circuit, if allowed to stand, will create a regulatory loophole in the Commission's jurisdiction under the Natural Gas Act ("NGA") through which future lease sale transactions can slide.[3] The simple answer is that Congress

[3] All the petitioners in one form or another state that "this case presents an important question concerning the scope of the Commission's jurisdiction under the Natural Gas Act." Pet. of FERC (No. 82-1618), page 10; Pet. of California (No. 82-1321), page 13;

has already determined through passage in 1978 of the Natural Gas Policy Act ("NGPA") to terminate the Commission's jurisdiction under the Natural Gas Act with respect to such future transactions. Thus, as a result of Congress' passage of the NGPA, this case stands alone and has no precedential effect as to new lease sale transactions because such new transactions are by law now exempt from the NGA.

Through passage in 1978 of the Natural Gas Policy Act, Congress determined to freeze the jurisdiction of the Commission under the Natural Gas Act, and to limit the scope of the NGA to that natural gas which had already been committed or dedicated under the NGA. By NGPA § 601(a)(1)(A), 15 U.S.C. § 3431(a)(1)(A), Congress excluded from all future jurisdiction of the Commission under the NGA first sales of natural gas which was not committed or dedicated to interstate commerce as of November 8, 1978, the day before the date of the enactment of the NGPA. Even with respect to natural gas which was already dedicated under the NGA, NGPA § 601(a)(1)(B), 15 U.S.C. § 3431(a)(1)(B), removed from any continuing Commission jurisdiction under the NGA high-cost natural gas [as defined in Section 107(c), 15 U.S.C. § 3317(c)], new natural gas [as defined in Section 102(c), 15 U.S.C. § 3312(c)], and natural gas produced from new onshore production wells [as defined in Section 103(c), 15 U.S.C. § 3313(c)].

In *Pennzoil Co. v. FERC*, 645 F.2d 360, 380 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142, the Fifth Circuit explained the NGPA's restriction on the Commission's NGA jurisdiction. The Fifth Circuit observed that the effect of NGPA § 601(a)(1) was to prevent "the universe of gas subject to the NGA from expanding" and to remove "from continuing NGA jurisdiction sales of certain gas

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Pet. of Oregon (No. 83-1432), page 13; Pet. of Northwest (No. 83-1433), page 14; Pet. of El Paso (No. 83-1442), page 12; and Pet. of Pacific (No. 83-1443), page 2.

that nevertheless was committed or dedicated to interstate commerce on November 8, 1978." Similarly, in *Public Service Commission of the State of New York v. Mid-Louisiana Gas Co.*, —— U.S. ——, 103 S. Ct. 3024, 3031, 77 L.Ed.2d 668, 678 (1983) this Court explained:

> The NGPA is designed to preserve the Commission's authority under the NGA to regulate natural gas sales from pipelines to their customers; however, it is designed to supplant the Commission's authority to establish rates for the wholesale market, the market consisting of so-called "first sales" of natural gas.

Thus, it is clear that, by passage of the NGPA, Congress has precluded prospective application of the NGA to natural gas which was not already committed or dedicated on November 8, 1978, when the NGPA was enacted.

As a result, lease sales consummated today, or at any time after the effective date of the NGPA, are exempt from any jurisdiction of the Commission under the NGA even if lease sales are construed to be sales of gas.[4] This is so because such leases sales would generally involve new natural gas that had not previously been produced and therefore had not been committed or dedicated prior to 1978. Being of such uncommitted stature, NGPA § 601(a)(1)(A) would expressly preclude application of the Commission's jurisdiction under the NGA to such lease sales, even if they constituted sales of gas. Consequently, even if the petitioners were correct in their argument that the Fifth Circuit's opinion restricts the Commission's jurisdiction under the NGA, their argument

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[4] Assuming *arguendo* that lease sales may be construed as sales of gas, the only exception to this statement is the unlikely instance where a new lease sale might involve gas that was already committed or dedicated prior to enactment of the NGPA. But even as to these lease sales the Commission would retain its pre-existing NGA jurisdiction only if the gas involved was not "new high cost gas," "new natural gas," or "gas from new onshore wells." See NGPA § 601(a)(1)(B). Respondents are not aware of any such lease sales of previously committed gas having been made since passage of the NGPA, and petitioners cite to none.

provides no basis for granting certiorari because Congress has already determined by enactment of the NGPA to preclude Commission jurisdiction under the NGA with respect to such sales.

Since the NGPA now bars the ultimate question presented in this case from arising again, the petitions for a writ must fail. An analogous situation arose in *Rice v. Sioux City Memorial Park Cemetery, Inc.*, 349 U.S. 70 (1955). In that case, after oral argument and affirmance by an equal division of this Court, it became evident, on a petition for rehearing, that a subsequently enacted state statute "bars the ultimate question presented in this case from again arising in that State." 349 U.S. at 73. Accordingly, the Court dismissed the writ as "improvidently granted." To the same effect is *Cook v. Hudson*, 429 U.S. 165 (1976).

A student of this Court's practice, Mr. R. L. Stern, has stated:

> The first and obvious conclusion to be drawn from the cases discussed is that a conflict will not necessarily result in the granting of certiorari if the issue is no longer a live one. In the first four cases the statute upon which the controversy rested had expired or been amended in a manner which would prevent the problem from arising in the future. In each case, it was nevertheless true that a substantial number of pending or potential cases would still be controlled by resolution of the conflict. But this did not convince the Court that review of the decisions of the court of appeals was warranted.[5]

So far as respondents are aware, there are no pending cases involving the assertion of NGA jurisdiction over lease-sale transactions. The only real question petitioners raise is "no longer a live one," but turns only on the particular facts of this case alone under the Natural Gas Act.

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[5] Stern, *Denial of Certiorari Despite a Conflict*, 66 Harv. L. Rev. 465, 470 (1953).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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Nos. 83-1321, 83-1432, 83-1433, 83-1442,
83-1443 and 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
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v.

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Respondents

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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SUPPLEMENTAL MEMORANDUM OF RESPONDENTS, WILLIAM G. WEBB, *ET AL.*

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IN THE

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---

SUPPLEMENTAL MEMORANDUM OF RESPONDENTS, WILLIAM G. WEBB, *ET AL.*

William G. Webb, *et al.* ("Webb parties"),[1] respondents herein, file this supplemental memorandum pursuant to the notice of the Clerk of this Court, dated

[1] This supplemental memorandum is filed on behalf of the respondents specifically enumerated at page 1, fn. 1, of the Brief of Respondents, William G. Webb, *et al.* in Opposition, filed May 11, 1984. It should be understood that throughout the course of these proceedings the Webb parties do not waive and specifically reserve their rights under the doctrines of collateral estoppel and *res judicata* which they raised below, but which the Court below did not address. 708 F.2d 1011 at 1020 (App. 1a at 19a).

May 31, 1984. By said notice, counsel were invited to address the offer of settlement and joint request for approval of stipulation of the settlement and agreement that was filed with the Federal Energy Regulatory Commission ("Commission") on May 18, 1984, as said settlement or other agreed upon settlements bear on the pending petitions for writs of certiorari.[2] The Webb parties submit that the settlement agreements already executed between various parties in these proceedings further demonstrate that this case is not one which warrants an affirmative exercise of this Court's extraordinary and discretionary certiorari jurisdiction.

As the Webb parties pointed out in their Brief in Opposition, p. 4:

> Thus, as a result of Congress' passage of the NGPA,[3] this case stands alone and has no precedential effect as to new lease-sale transactions because such new transactions are by law now exempt from the NGA.[4]

No party in any of the reply briefs that have been submitted has challenged the conclusion that the NGPA has limited this case to its facts. In fact, as the Government states in its Reply Memorandum for the Petitioner, p. 5:

> —we submit that the future ramifications of this *one case alone* are themselves sufficiently substantial to warrant certiorari. (emphasis added).

Assuming *arguendo* the "fall back" position of the petitioners to be correct that the facts of this single case

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[2] On May 30, 1984, Petitioner, El Paso Natural Gas Company ("El Paso") and Respondents, Tenneco Oil Company ("Tenneco") and Conoco Inc. ("Conoco") filed a joint suppleemntal brief advising this Court that a comprehensive settlement agreement had been entered into between El Paso and Tenneco and Conoco, which was being filed with the Federal Energy Regulatory Commission on May 18, 1984.

[3] Natural Gas Policy Act of 1978, 15 U.S.C. § 3301, *et seq.*

[4] Natural Gas Act of 1938, 15 U.S.C. § 717, *et seq.*

alone justify certiorari, the settlement agreements would severely restrict the area left to be adjudicated. Thus, the issue which the petitioners seek to present on certiorari is no longer a "live one," either in the context of a pervasive precedent or in the context of the facts of this case, itself.

This case involves lease sales to Northwest Pipeline Corporation ("Northwest") and El Paso Natural Gas Company ("El Paso"). Lease sales to Northwest are designated as "PLA's," and those to El Paso as "GLA's." The Commission by order of November 23, 1983, 25 FERC ¶ 61,292, has already approved a settlement involving PLA-5 between Northwest and Phillips Petroleum Company. PLA-5 is the largest of the PLA's covering approximately 202,000 acres of land in the San Juan Basin. 25 FERC at 61,672. The Commission by order issued March 30, 1984, 26 FERC ¶ 61,421 also approved a settlement involving PLA-3 between Northwest and Getty Oil Company. El Paso has entered into a settlement agreement with Union Oil Company of California dated November 11, 1983, and filed with the Commission on December 13, 1983, involving GLA's 76, 348 and 349. The latest GLA settlement agreement to surface is that about which this Court was recently apprised. Such agreement is between El Paso and Tenneco-Conoco and involves GLA's 47, 52, 60 and 78. These four GLA's represent nearly seventy percent of the El Paso volumes that are involved here. Although the two El Paso settlement agreements have not been as yet approved by the Commission, the fact remains that there is comparatively little acreage and gas remaining outside of that involved in the settlement agreements. In other words, there is little left that a decision of this Court, even if certiorari were granted, can affect.

For the foregoing reasons and those stated in our brief in opposition, the petitions for a writ of certiorari should be denied.

Respectfully submitted,

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1. The Public Importance Of This Case

Producers' principal defenses are that the case is "prospectively moot" because gas consumers (as opposed to the pipelines) face no risk of future exploitation and that refunds to consumers for exploitation in the past are uncertain. These defenses are without merit.[1]

[1] Producers also contend that the GLA/PLA transactions are *sui generis*. There is no evidence in the record, however, that the GLA/PLA transactions, along with the lease sales found jurisdictional in the 1960s, are the entire universe of jurisdictional lease sale transactions. An assertion to that effect would be incorrect.

Mid-La[2] did not change the statutory duty of the FERC[3] under the NGA[4] or the NGPA[5] to regulate sales of gas by producers. *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 394 (1974) ("No producer is exempt from §§ 4 and 5."). Indeed, the protection of gas consumers from exploitive prices requires that the FERC regulate the producer as well as the pipeline. "Control limited to approving the costs of the gas to the purchasing pipeline is, of course, not an effective way to regulate producer prices because in the large a pipeline must be allowed to pass on its purchased gas costs to the ultimate consumer or it cannot continue to discharge its public service responsibilities." *Texas Eastern Transmission, Corp.*, 29 F.P.C. 249, 255-56 (1963) (FPC's *Rayne Field* decision). "Throughout the years in controversies such as *Phillips* and *CATCO*, the FPC has sought to justify inaction at the level of producer rates on the ground that the pressures built up by producer rate increases could somehow be contained at the pipeline level by invoking a regulatory agency's authority to disallow 'excessive' costs. And throughout the years, the [Supreme] Court has found this professed substitute inadequate." *Consumer Federation of America* v. *FPC*, 515 F.2d 347, 357-58 (D.C. Cir.), *cert. denied*, 423 U.S. 906 (1975). According to this Court, ". . . rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong." *FPC* v. *Memphis, Light, Gas & Water Div.*, 411 U.S. 458, 474 (1973).

If the decision below is not reversed, the GLA producers and the non-settling PLA producers will long continue to reap windfalls never contemplated by Congress under the NGA or the NGPA. Moreover, El Paso anticipates that the GLA producers, unless restrained by regulation, will contend that their special overriding royalty should just about *triple* on and after

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[2] Public Service Comm'n of New York v. Mid-Louisiana Gas Co., 103 S. Ct. 3024 (1983).

[3] Federal Energy Regulatory Commission.

[4] Natural Gas Act, 15 U.S.C., §§ 717-717w (1982).

[5] Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1982).

June 1, 1985. It is obvious that El Paso will ask gas consumers to shoulder the impact of such a dramatic escalation of an already excessive payment.[6] On Northwest's system, Phillips and Getty have accepted regulated prices, under settlements approved by the FERC, but the other PLA producers (Amoco, Atlantic, Mobil) like the GLA producers claim that they should receive several times more than these maximum lawful prices. If Northwest is required to pay these excessive demands, it will have no alternative but to seek from the FERC special relief permitting it to pass these payments onto ratepayers.

Accordingly, if the Court of Appeals opinion stands, its economic impact will extend far into the future. There are still

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[6] The representation of Tenneco, *et al.* of no prospective consumer impact is disingenuous. In the Texas state court litigation, Tenneco's expert testified that "El Paso would have an excellent chance of having [special relief] granted . . . ." El Paso Natural Gas Co. v. Tenneco Oil Co., No. 83-50539, 11th Judicial District, Harris County, Texas, transcript of January 26, 1984, p. 105. The Commission in approving the Phillips-Northwest PLA 5 settlement (discussed in the text, *infra*), noted that "Phillips is offering to accept rates under PLA 5 that could save Northwest, *and eventually its consumers*, as much as $50,000,000 a year." 25 FERC ¶ 61,292 at 61,674 (1983) (italics added). Thus, the FERC recognized that it is uncertain that the pipelines will bear the entire cost of high special overriding royalties in the future if the GLA/PLAs are not jurisdictional sales. The producers point out that El Paso presently offsets GLA production losses against profitable production on non-GLA properties. Producers' contention is irrelevant; the fact that El Paso has other profitable operations in no way justifies producers' continuing receipt of unregulated revenues in violation of the NGA and NGPA. Producers in their argument that El Paso and not the consumers can bear the future impact cite a study prepared for a different purpose by El Paso's reservoir engineering department. The study did not take into account the dramatic increase in the special overriding royalty that producers will seek after June 1, 1985. As of this time, El Paso has not sought special relief, but, contrary to the assertion in Tenneco's Brief at 10 n.19, El Paso's witnesses did *not* testify in the Texas state court case that the FERC would likely deny special relief if reassignment failed. (They testified that the FERC would likely deny special belief so long as El Paso had reassignment rights which it could exercise—rights which the state court subsequently said could not be exercised.) The only way to ensure that the consumer does not face substantial increased costs in the future is through a jurisdictional decision in this case.

some 3 trillion cubic feet of gas under the GLA/PLA leases,[7] and production from these leases, burdened with high special overriding royalties allowed under the Fifth Circuit's decision, will continue for 20 years or more. The FERC, required to protect both gas consumers and the legitimate interests of pipelines, will be confronted with unsatisfactory choices for either, guaranteeing endless litigation.

Producers try to minimize the amount of the refunds claimed in the FERC remedy proceeding, but it is obvious that the producers have been paid far more than they should have been paid in the past. If the decision below is reversed, petitioners will have the opportunity in an FERC remedy proceeding to prove that the GLA producers must refund more than $1 billion for the benefit of gas consumers on El Paso's system and, excluding Phillips and Getty, $50 million for Northwest's consumers.[8] Producers assert that these refund claims are exaggerated, and point to the $32 million refund that Phillips and Getty have agreed under their settlements to make to Northwest's consumers in the event of a jurisdictional determination by this Court. However, these settlements were made after the decision of the Fifth Circuit and represent a substantial compromise of past refund liability given in return for Phillips' and Getty's agreement to accept in the future regulated pricing, including an "old gas" price, less North-

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[7] Last year, the city of Washington, D.C. consumed 292,354,000 therms of natural gas. At the 1983 consumption rate, 3 Tcf would supply the city of Washington for more than 100 years.

[8] The Commission unquestionably has the power to order refunds in this case, and could restructure the agreements from their inception, as it did in the *Rayne Field* remedy case. Public Service Comm'n of New York v. FPC, 543 F.2d 757 (D.C. Cir. 1974), *cert. denied*, 424 U.S. 910 (1976). Petitioners and the FERC Staff have sought refunds only back to 1974 when producers were placed on notice of their liability. The 1974 Settlement Agreements provided that the payments made under the agreements were subject to Commission order in the event of a final jurisdictional determination. Even if the producers were somehow successful in fixing the commencement of their liability at the date of the FERC's jurisdictional decision in 1980, they would still be subject to refunds of about $500,000,000.

west's cost of producing the gas.[9] As a consequence, Phillips and Getty today are paid about 86¢ per MMBtu less Northwest's production costs per MMBtu for "old gas," whereas the GLA producers are receiving an incentive "new gas" price, now $3.35 per MMBtu less 7¢, for all gas, including "old gas."

In providing for incentive pricing under the NGPA, Congress never intended that producers in an established field, such as the San Juan Basin, could obtain such high prices for "old gas." Yet, this has happened and will continue to happen unless this Court closes the regulatory gap opened up by the court below.

2. The Lease Sales Were Jurisdictional Sales

Producers, citing the FERC Petition at 19, agree with the Commission that "the dispositive question [under *Rayne Field*] is whether what was sold was gas or merely the right to explore for gas." PLA Respondents' Brief at 13; Union Brief at 15. The producers claim that only the right to explore for gas was transferred under the GLA/PLA lease sales, even though the pipelines could not have been certificated, financed and built or expanded unless the GLA/PLA reserves were found to be proven[10] and immediately available upon completion of the

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[9] Phillips and Getty in effect accepted the pricing remedy for the future proposed by Northwest in the aborted FERC remedy case. The Commission found that "the settlement assures ratepayers secure future rates in return for the giving up of *substantial refunds* in the event the Former Fifth Circuit is reversed." 25 FERC ¶ 61,292 at 61,674 (1983) (italics added). The Commission was here referring to pre-1980 refunds. These two settlements provided for full refunds back to September 1980 contingent upon a final jurisdictional decision. Further, in the event of a jurisdictional determination, Phillips and Getty agreed that they may be required to accept a lower old gas price than is now used for valuing their old gas.

[10] As of 1951, the American Gas Association defined "proved reserves" as follows: "Proved reserves may be in either the drilled or undrilled portions of a given field. Where the undrilled areas are considered proved, they are so related to the developed acreage and to the known field geology and structure that their productive ability is considered assured. Proved recoverable reserves of natural gas are the reserves estimated to be producible under present operating practices." Report of The Committee on Natural Gas

pipeline facilities to provide the certificated gas service.[11] Judge Benkin specifically found that the reserves under each GLA/PLA were proven,[12] the FERC adopted his findings, and, despite producers' obfuscations,[13] the Fifth Circuit did not upset the agency's expert finding that the reserves were proven. In the case of GLA 47, this Court can see that the acreage transferred by Delhi was proven from the map submitted by Tenneco.[14] Thus, producers' contention that merely rights to explore unproven lands rather than proven gas reserves were sold under the GLA/PLA transactions is in con-

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Reserves of the American Gas Association, Year Ended December 31, 1951. A prudent operator in a proven area will therefore always drill a commercial well. R. 908, 1507.

[11] In the San Juan Basin, a development well in the 1950s required 30 days or less to drill. The development wells were drilled while the pipelines' gathering systems were being extended. Neither producer nor pipeline drills development wells ahead of the time that the pipeline can tie into the well. *See* El Paso Petition, No. 83-1442, at 6 nn.3 and 4.

[12] App. 52a-56a, 106a-07a.

[13] An example is Tenneco's Brief at 7 n.15. DeGolyer & MacNaughten specifically found the GLA 47 reserves were proven, as discussed in the PGandE and SoCalGas Petition, No. 83-1443 at 10-11. The California companies were seeking yet additional supply in the Basin. The memorandum cited by Tenneco in note 15 makes the point that additional drilling was needed to prove up reserves *beyond* the then established field limits in order for the entire Blanco area to be proven. This drilling was underway. *See* note 14, *infra*. Another example is the PLA producers' characterization that Amoco's PLA acreage was "an awful lot of goat pasture." PLA Respondents Brief at 21 n.29. An Amoco witness testified before Judge Benkin that Amoco's predecessor Stanolind transferred proved reserves. R. 1909, R. 1920.

[14] Outlined in red on the map lodged by Tenneco with this Court are the Mesaverde field limits as determined by El Paso and the state of New Mexico in early 1952. Field limits delineate the areal extent of proven reserves. Delhi's acreage is colored blue on the map. R.21053 All blue acreage within the red line was proved, according to El Paso and the state of New Mexico (as well as Delhi), at the time. R. 21053 This acreage, according to Delhi, contained proven, recoverable reserves of 1.063 Tcf. R.9692 Subsequent drilling in the 1950s rapidly expanded the proven field limits to include several times the proven area shown on the map. El Paso and Northwest conclusively showed that proven reserves were assigned under each GLA/PLA transaction. *E.g.*, R. 9971-10038.

flict with the findings of the agency accepted below. These agency findings, supported by substantial evidence, were conclusive on the court below. NGA § 19(b), 15 U.S.C. § 717r(b).

Because the GLA/PLA reserves were proven,[15] the producers knew the economics (reserves, capital cost, operating expense) of producing the gas, and therefore structured lease sales that returned to them the same net income that they would have received under conventional sales.[16] The cost of development drilling was simply one of a number of factors taken into account in calculating the payment to be received by the producers, just as in *Rayne Field*, *Bastian Bay*, and *Ship Shoal* (see appendix).[17] The FERC's findings of proven reserves and economic equivalence, both of which were accepted by the court below, means that the producers sold gas and not the right to explore for gas through the lease sale transfers. *See* App. 109a-110a. The absence of any particular number of development wells cannot change this dispositive fact.

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[15] See definition of proven reserves in note 10, *supra*.

[16] Delhi's studies demonstrating this fact are in evidence (R. 9692, R. 5130); Union's predecessor made the same determination (R. 20787); Skelly estimated that it would receive two cents more per Mcf than under a conventional wellhead sale (R. 12870); C. E. Turner, a Phillips economist, testified that the lease sale "was just about as good or better than [Phillips] could [obtain] by drilling the acreage [itself], and selling the gas from day to day." R. 14279.

[17] Producers here seek to distinguish the trilogy on various hairsplitting grounds that the expert agency rejected as without merit. App. 105a-107a. For example, the only purpose of the "upfront" payment in Ship Shoal was to reimburse the producers for capital investment, just like the payments for existing wells here. R. 5149 In fact, the GLA 47 and Ship Shoal transactions are remarkably close, as shown by the Appendix to this Reply. Producers also misstate the facts of Ship Shoal; at closing, 12 wells, not 17, had been drilled: "One gas well has been completed; it has been and still is shut-in with no gas produced (J.A. 4-5). Seven oil wells have been completed and have been producing since 1960 (ibid.). Four dry holes had been drilled (ibid.)." Producers' Petition for Certiorari, Continental Oil Co. v. FPC, No. 1323, October Term, 1966, pp. 3-4; see also Tennessee Gas Transmission Co., 30 F.P.C. 759, 799 (1963). The five potential gas wells were drilled by the pipeline after closing, not by the producers. 30 F.P.C. at 803.

Producers do not attempt to defend the Court of Appeals' decision that in order for a lease sale of gas to be jurisdictional there must be present on the leasehold sufficient development wells to deplete the proven reserves. Rather, producers argue that unless substantial development exists the lease sale fails the proven reserve requirement or the economic equivalent test. Tenneco contends that unless substantial development exists "a sale of gas in place is impossible because a definable volume of gas is uncertain, and estimates of reserves cannot be relied upon by the parties to the transfer." Tenneco Brief at 13. Similarly, the PLA producers maintain that this Court in *Rayne Field* required substantial development for "verification of the estimated reserves thought to underlie the acreage" in order to have a sale of gas. PLA Respondents' Brief at 14. On the other hand, Union, alone in acknowledging the lower court's treatment of substantial development as a jurisdictional requirement, separate and apart from whether reserves are proven, asserts that if the "risks and expenses" of development wells[18] are transferred to the buyer "then the lease sale simply cannot be economically equivalent to the sale of gas." Union Brief at 16, 17.

The failure of the producers directly to defend the decision below underscores its gross misapplication of *Rayne Field*. In fact, under the Tenneco-Phillips rationale, *Rayne Field* could *never* have been a jurisdictional lease sale. In 1959, at the time of that lease sale, "a major unknowable was the volume of gas which the transferred reserves would ultimately yield, and consequently the eventual unit price which Texas Eastern would pay for the yield." *Public Service Comm'n of New York* v. *FPC*, 543 F.2d 757, 783 (D.C. Cir. 1974), *cert. denied*, 424 U.S. 910 (1976) (*Rayne* remedy case).[19] In connection with

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[18] When the reserves are proven, there is no significant risk in drilling development wells. See note 10, *supra*. The risk is in drilling exploratory wells, *not* development wells. R.908.

[19] The producers, as well as the Fifth Circuit, know that reserve estimates vary considerably and that substantial development is not required to verify proven reserve estimates traditionally relied upon by producers, pipelines the Commission, and lenders. See Ship Shoal, 370 F.2d at 65 ("We recognize

Union's position, the evidence here showed that the producers structured the economic equivalent of a conventional sale without development wells,[20] and the court below never disputed the agency's finding of equivalence.

It is indefensible to deny jurisdiction over lease sales which the Commission found based on substantial evidence to be assignments of proven reserves that were economically equivalent to conventional sales simply because the pipelines were required by the producers to drill the development wells. If primary jurisdiction means anything, the court below should surely have deferred to the agency's judgment that development drilling was not needed here to accomplish jurisdictional sales of gas by these lease sales.[21]

3. Producers Are Not Royalty Owners

Producers here seek refuge under the *Mobil* case.[22] They contend that they are nothing more than passive royalty owners who engaged in unregulated land transactions even though such royalty owners typically are paid on 12½% of the value of the production, whereas the GLA and PLA producers are paid on 70% to 85% of the value of the production. True royalty owners, such as the respondent farmers in the market value royalty cases currently pending before this Court,[23] under-

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that estimates of reserves in Ship Shoal may vary considerably until the field is fully drilled and there is productive history over a period of years under operating conditions.").

[20] See note 16, *supra*.

[21] In Ship Shoal, the producers also argued that the reserves were unproven, and there were no gas development wells. Nevertheless, the court affirmed the agency's jurisdictional determination without any development wells because of the purchasing pipeline's "willingness to invest over $97 million on its faith in the lowest of the reserve estimates" and because "its readiness to connect its lines to *Ship Shoal* is a strong indication that the field was 'substantially developed' at the time of transfer." 370 F.2d at 65. The GLA/PLA transactions had similar and considerably more persuasive facts.

[22] Mobil Oil Corp. v. FPC, 463 F.2d 256 (D.C. Cir. 1971), cert. denied, 406 U.S. 976 (1972).

[23] Nos. 83-1234, 83-1248 & 83-1278.

stand the vast difference between themselves and the producers. As the farmers inform this Court:

> Overriding royalty interest owners, as sellers of gas or leases, such as producer-respondents in Nos. 83-1321, 83-1433 and 83-1618, may of course be subject to the Commission's jurisdiction under the National Gas Act. Not even a transparent similarity exists between respondent landowners' rental involved herein and the producers' overriding royalty interests as lessees in Nos. 83-1321, 83-1433 and 83-1618.[24]

Because the GLA/PLA producers are paid on the entire net interest assigned, they are capturing more than 400% of the regulated value of the gas, as opposed to the situation in the market value royalty cases where several of these same producers complain about the landowner capturing 60% of the regulated value.[25] The GLA/PLA reserves remain a major and necessary gas supply for western gas markets. It is imperative that this Court ensure that the producers' continuing exploitation of consumers and pipelines dependent on this supply be brought to a halt.

4. Conclusion

The petitions should be granted.

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[24] Brief of Respondents in Opposition, Ashland Oil Co. v. Good, et. al., Nos. 83-1234, 83-1248 & 83-1278 at 21 n.18.

[25] See FERC Petition for Cert., FERC v. Tenneco Oil Co., No. 83-1618 at 22 n.17, where the FERC explains that the financial impact here far exceeds that in the market value royalty cases.

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APPENDIX

Comparison of GLA 47/Ship Shoal

	GLA 47	Ship Shoal
1. Recoverable Reserves As Estimated By Producer *Before* Lease Sale Execution	1.063 Tcf (R.9692)	730 to 823 Bcf (370 F.2d at 65)
2. Reserves Producible In Four Years As Estimated By Producer	16.8% (or 179 Bcf) (R.9692)	10% (or 73 to 82.3 Bcf) (370 F.2d at 66)
3. Estimated Life Of Property	25 years (R.9692)	26 years (30 F.P.C. at 803)
4. Specified Development Program	Yes (R.4098-101)	Yes (R.14169)
5. Capital Investment[1] Over Life Of Reserves	$20,000,000 (R.9692)	$13,104,000 (30 F.P.C. at 803)[2]
6. Capital Investment At Closing	$1,021,000 (R.5149)	$1,999,000 (30 F.P.C. at 803)
7. Closing Payment[3]	$1,021,000 (R.5149)	$1,925,000 (30 F.P.C. at 801)
8. Pipeline Operating Expense Over Life Of Reserves As Estimated By Producer	$595,000 (R.9692)	$31,009,000 (30 F.P.C. at 803)
9. Method Of Payment	Cents Per Mcf as produced	Advance payments as scheduled by notes

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[1] As used in this comparison, "capital investment" means the amount invested in depreciable gas property.

[2] $1,999,000 at closing ($2,280,000 × 87.6712%) + 8,260,000 + 2,845,000. 30 F.P.C. at 803.

[3] The producers call this the "upfront payment." It is exactly the same as capital investment at closing in GLA 47 and nearly the same in Ship Shoal.

Comparison of GLA 47/Ship Shoal

	GLA 47	Ship Shoal
10. Reserve Redetermination	No[4]	Yes,[5] in 7th year
11. Overall Consideration For Reserves	Net interest payment[6] (geared to production) + capital and operating costs shifted to pipeline	Net interest payment (geared to production) + capital and operating costs shifted to pipeline

[4] Not needed as payment per Mcf.

[5] The purpose was to enable the parties to readjust the price depending on remaining reserves as estimated upon significant production history.

[6] In jurisdictional lease sale transfers of the type involved here, the producer assigns the working interest to the pipeline, and the pipeline then bears the royalty expense. The producer is paid on the entire volume remaining after subtraction of royalty volume. This payment at least in the early years is less than the field or in-line price in recognition that under the lease sale form capital and operating costs have been shifted to the pipeline.

Nos. 83-1321, 83-1432, 83-1433, 83-1442, 83-1443 & 83-1513

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, et al.,
Petitioners,

vs.

TENNECO OIL COMPANY, et al.,
Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals For the Fifth Circuit

JOINT SUPPLEMENTAL MEMORANDUM OF PETITIONERS CALIFORNIA AND NEVADA CONCERNING PROPOSED SETTLEMENTS

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JOINT SUPPLEMENTAL MEMORANDUM OF PETITIONERS CALIFORNIA AND NEVADA CONCERNING PROPOSED SETTLEMENTS

I

INTRODUCTION

Pursuant to this Court's May 31, 1984 order, the People of the State of California and the Public Utilities Commission of the State of California ("California"), petitioners in No. 83-1321, and the Public Service Commission of Nevada ("Nevada"), a petitioner in No. 83-1432, hereby file this supplemental memorandum concerning the pending offer of settlement between petitioner El Paso Natural Gas Company ("El Paso") and respondents Tenneco Oil Company ("Tenneco") and Conoco Inc. ("Conoco"), as well as other settlements between parties in this proceeding. California and Nevada represent the ratepayers in their respective states, who rely heavily on the natural gas which El Paso transports to them from the San Juan Basin and are therefore greatly affected by any settlements pertaining to the future price and supply of this gas. Nevada also represents ratepayers in its state who rely on the natural gas which Northwest Pipeline Corporation ("Northwest") transports to them from the San Juan Basin.

Ever since 1974, after El Paso had unilaterally settled with the San Juan Basin natural gas producers ("the producers") as to the price it would pay for the special overriding royalties under the subject Gas Lease-Sale Agreements (GLAs), El Paso, California and some of the other petitioners herein have been litigating the jurisdictional issue which is presently before this Court.[1] Throughout the

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[1]The Federal Power Commission (predecessor to the Federal Energy Regulatory Commission ("the Commission"), allowed these settlement rates to be passed onto El Paso's customers, and ultimately the ratepayers in the western states who have been paying these overcharges throughout this litigation. In so doing, the Commission found it *significant* that in that settlement, El Paso had not given up its "best hope for relief from these special overriding royalty charges" since El Paso had maintained its right to continue litigating the jurisdictional question, and if El Paso were successful, the refund of these overcharges could be flowed back to the ratepayers. *El Paso Natural Gas Co.*, 57 F.P.C. 989, 999 (1977).

course of this jurisdictional litigation, settlement negotiations between El Paso and the producers have always included counsel for some of the petitioners herein, including California. Thus, for approximately ten (10) years, El Paso and the other petitioners have shared common ground in trying to prevent future gas prices under the GLAs from escalating significantly beyond proper regulation (and market-clearing prices), as well as in seeking refunds to ratepayers for past overcharges.

The present offers of settlement between El Paso and some of these producers sharply contrasts with this decade of previous cooperation and mutual interests between El Paso and the other petitioners herein. El Paso did not include any of the other petitioners in its settlement negotiations resulting in its agreement with respondent Union Oil Company of California ("Union").[2] Similarly, El Paso did not include any of the other petitioners in its settlement negotiations with Tenneco and Conoco. Instead, El Paso presented its offer of settlement (consisting of approximately 1000 pages) as a fait accompli to petitioners just before it filed its offer with the Commission. Initial comments on this offer of settlement, including requests for a hearing, are currently due at the Commission on July 2, 1984. Many

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[2]While this settlement agreement was in the context of El Paso's reassignment state court litigation in the District Court, 11th Judicial District, Harris County, Texas, many issues, such as the future price and supply of this gas, remain unresolved and may be the subject of the Commission proceeding on Union's certificate application in Docket No. CI84-141-000. Because this settlement may adversely affect El Paso's service to its customers, the Commission in its May 10, 1984 order required Union to make the settlement a part of the record. (See p. A-5 of the order in the attached appendix.) Notwithstanding the Commission's order, Union has not filed this settlement with the Commission and has refused to supply parties with a copy. While El Paso did furnish California with a copy of the settlement on June 7, 1984, we have not had sufficient time to analyze it for our filing with this Court.

of the petitioners herein intend to demand a hearing and the offer of settlement will be contested.

On the eve of this Court's conference to decide whether to grant certiorari in this case, El Paso, Tenneco and Conoco have brought to this Court's attention their offer of settlement, notwithstanding its lack of finality. These are the very companies (i.e., natural gas producers and a pipeline company) that Congress recognized must be regulated or else they would exploit consumers, *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 685 (1954), and they have entered into a settlement agreement with no participation or concurrence by the other petitioners, including those, such as California and Nevada, which represent the ratepayers. By its implication that this Court should deny certiorari (leaving final the decision of the court below) the untimely disclosure of the offer of settlement is a last ditch attempt to thwart the pricing protections that Congress had intended for all wholesales of natural gas in interstate commerce. Yet, the deliberate exclusion of the other petitioners, including those representing the ratepayers, from the settlement negotiations strongly indicates that the offer of settlement is not in the public interest. The only way to assure that the ratepayers in the western states will not be exploited by these companies is for this Court to grant certiorari and find that the Commission has jurisdiction over the subject lease-sales of natural gas.

II

THE COMMISSION CAN ONLY PROTECT THE PUBLIC INTEREST IF THIS COURT GRANTS CERTIORARI AND DETERMINES THAT THE COMMISSION HAS JURISDICTION OVER THE LEASE-SALES

Just as a court without subject matter jurisdiction is unable to assure a just resolution of a dispute, so too is the Commission unable to assure that the public interest will best be served in the present case unless and until this

Court grants certiorari and finds that the Commission has jurisdiction over the lease-sales in question. Consequently, it is realistic to expect that the Commission will await this Court's ruling on the Commission's jurisdiction before it finally determines whether the public interest supports the proposed settlements.

In the event that this Court finds that the Commission has jurisdiction, the Commission would have much more authority and alternatives in serving the public interest while reviewing the proposed settlements.[3] If the Commission has jurisdiction, we submit that it would not approve the present proposed settlements, because they are too detrimental to the western states ratepayers. Instead, the Commission could resume its remedy proceeding which had been close to trial before the court below issued its decision. The Commission's ability to protect the public interest is significantly circumscribed, however, if the decision of the court below is not reversed. Without Commission jurisdiction over the lease-sales, the producers would not be legally required to abide by any Commission decision except one approving the present offers of settlement under the terms, conditions and schedules dictated by the producers. Otherwise, the producers can walk away from these offers of settlement and attempt to triple their special overriding royalties on June 1, 1985, in which event El Paso has indicated it would then seek special relief to pass these costs onto the ratepayers.

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[3]The difference in how the Commission can review the proposed settlements depending upon whether it has jurisdiction is aptly demonstrated by its decision in *El Paso Natural Gas Co.*, 57 F.P.C. 989 (1977) when it passed the costs of the special overriding royalties onto the ratepayers. As the Commission informed this Court in its reply memorandum, "the Commission specifically stated that it was 'not deciding whether the amounts received by the special overriding royalty owners, *were they found to be jurisdictional*, are just and reasonable.' (57 F.P.C. at 1000)." [Emphasis added.] (FERC reply, pp. 7-8, fn. 7).

Without this Court's determination that the Commission has jurisdiction over the lease-sales, the Commission is powerless to order refunds by the producers for nearly a decade of overcharges to ratepayers in the western states. Tenneco and Conoco, whose GLAs account for approximately 70% of El Paso's natural gas involved in this case, have offered a total of $50 million in refunds in their proposed settlement, but this is a far cry from the $700 million which they would have to refund under California's and the Commission staff's theory of remedy. El Paso's "agreement" to this level of refund is preposterous, because the ratepayers have paid these overcharges since 1974 and El Paso is not authorized to settle the ratepayers' claim to these refunds.

In addition to this grossly inadequate level of refunds, the proposed settlements, if approved, would have severe effects on the future price and supply of the San Juan Basin natural gas for El Paso's customers. (See discussion, *infra.*) However, assuming *arguendo* that these offers of settlement are in the public interest and would not be devastating to the ratepayers, as we fear, the termination provisions of these settlements allow the producers to cancel the settlements under certain conditions which have already occurred or easily could occur. Under Union's and El Paso's settlement agreement, Union is already free to terminate the agreement, since the Commission has not yet issued Union a certificate of public convenience and necessity, and Union has an option to supersede this agreement with another one identical to the El Paso-Tenneco-Conoco offer of settlement.

Similarly, the El Paso-Tenneco-Conoco offer of settlement (pp. 24-25) provides:

"H. *Termination*

The Settlement may be terminated at the earlier of any of the following dates: (a) by either side if final

> Commission approval in a form satisfactory to such party has not issued within 15 months after the date of execution, (b) by Tenneco Oil and Conoco if such final approval has not issued within 180 days following denial of certiorari in the litigation now pending before the Supreme Court, and (c) by El Paso, if such final approval has not issued within 30 days following the final reversal of the decision in *Sun Oil, supra.* In addition, if the orders are unacceptable, any of the parties have the right to terminate the Settlement Agreement.
>
> Because the right to terminate arises in the event that the approvals are no longer subject to judicial review, expeditious consideration by this Commission is necessary to assure that approvals become final before the termination rights arise."

Under this agreement, if this Court denies certiorari, the Commission has only 180 days (really 150 days if one subtracts the 30-day period for filing petitions for rehearing) to finally approve the settlement. If any party opposes it or if it cannot be decided within 150 days because, for example, the producers are not cooperative in discovery, then Tenneco or Conoco can terminate the agreement. They can also terminate the agreement if the Commission's order is unacceptable.

Thus, if this Court denies certiorari, the producers are in absolute control of their settlement proposal. Tenneco and Conoco can dictate the time for discovery, hearings, briefing schedules, and the Commission's issuance of the decision on this settlement and even the form of the Commission approval of it. Of course, if the Commission denies the settlement or any party appeals the Commission's approval of it, the settlement can be terminated.

Clearly, this case is far from being settled. With Union able to presently terminate its agreement (and withdraw

its certificate application) and Tenneco and Conoco able to easily walk away from their offer of settlement, these are only, at best, possibilities of offers of settlement and they should not dissuade this Court from granting certiorari. It is certainly foreseeable that after having informed this Court of the alleged virtues of their proposed settlements, that in the event that this Court denies certiorari, the producers may ultimately terminate their settlement agreements and forever keep their lease-sales nonjurisdictional. The only way that the Commission can truly protect the public interest is by having jurisdiction over the subject matter while considering the settlement proposals.

III

THE RATEPAYERS FACE OMINOUS ALTERNATIVES IF THE PRODUCERS ESCAPE REGULATION THROUGH THIS COURT'S DENIAL OF CERTIORARI

Besides losing their opportunity to seek refunds for over $1 billion for past overcharges, the ratepayers in the western states face potentially severe prospective gas prices and/or supply impacts if this Court does not reverse the decision of the court below.

The proposed settlements between El Paso and Union (concerning approximately 14% of El Paso's gas in question) and El Paso and Tenneco and Conoco (concerning approximately 70% of El Paso's gas in question) can best be understood in the context in which they were entered. After El Paso implemented this Court's *Mid-Louisiana* decision, *Public Service Commission of New York v. Mid-Louisiana Gas Co.*, ... U.S. ....., 103 S.Ct. 3024, 77 L.Ed. 2d 668 (1983), which limited El Paso to Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. § 3301, *et seq.*, ceiling prices, it unsuccessfully sought in Harris County, Texas state court litigation to reassign the properties burdened by the special overriding royalties, which exceeded the applicable NGPA ceiling prices. During this litigation, Union vol-

untarily accepted reassignment, and in the Commission's proceeding on Union's certificate application (Docket No. CI84-141-000), Union seeks Section 109 pricing (15 U.S.C. § 3319) under the NGPA for old gas, which would more than double the price El Paso's customers currently pay for this gas, and would be more than four times the proper price of this gas (NGPA Section 104 flowing gas, 15 U.S.C. § 3314) if the Commission has jurisdiction over the lease-sales.

In the Commission proceedings, petitioners will for the first time have the opportunity to learn the full impacts of the settlement agreement between Union and El Paso. We are unable to detail them at this time, since we did not receive a copy of it until June 7, 1984 and have not yet had an opportunity to conduct discovery. However, in addition to the proposed increase in rates if Union receives the Section 109 pricing, we already recognize that western states ratepayers will be adversely affected by at least two of the provisions in Union's proposed gas purchase contract. First of all, El Paso has previously received revenues from its extraction of liquid hydrocarbon products ("liquids") from the gas under the GLAs. El Paso has credited these revenues to its cost of service thereby reducing the rates its customers must pay. In this proposed gas purchase contract, El Paso agrees to transfer 77% of the liquids revenues from El Paso's customers (and therefore ratepayers) to Union. Thus, El Paso's rates would increase due to the transfer of ownership of these liquids. Secondly, Union has a right to retain up to 25 % of the gas produced from new wells on these properties. Thus, in the event of any gas shortage in the future, El Paso's customers in the western states would be threatened by this reduction in El Paso's gas supply.

Tenneco and Conoco did not enter into their settlement agreement with El Paso until after they won the state court litigation and thus had even more leverage than Union in its settlement with El Paso. We are informed and believe

that after the state court's ruling, counsel for Tenneco and Conoco stated publicly to the press that the special overriding royalties could amount to $6 billion over 20 years.[4] Thus, this current offer of settlement where they have given up the right to collect these royalties would, undoubtedly, generously compensate the producers, and we fear this will be at the ratepayers' expense.

While petitioners need extensive discovery in the Commission proceedings to ascertain the full impacts that would occur if this proposed settlement is approved, we already recognize that western states ratepayers will be adversely affected in the future, besides losing over 90% of the refunds they should receive. Like the Union agreement, Tenneco and Conoco have reserved up to 25% of the new gas from these properties which would be a severe curtailment in El Paso's gas supply in the event of a gas shortage. Also, rates for old gas would more than double for the next two years and thereafter would fall under the interstate rollover rates under Section 106(a) of the NGPA, 15 U.S.C. § 1316(a), (currently priced at 89¢/MMBtu), whereas under proper regulation, the price should be approximately half of that according to the flowing gas rates of Section 104 of the NGPA, 15 U.S.C. § 3314, (currently priced at 49¢/MMBtu), if the Commission has jurisdiction over these lease-sales.

Most significantly, California and Nevada are apprehensive that western states gas consumers could face substantial increases in their rates from El Paso's transfer of liquids revenues from the ratepayers to Tenneco and Conoco. Similar to the Union agreement, El Paso has transferred at least 77% of its revenues for liquids from the

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[4]See *Houston Post* March 1, 1984 story in the appendix (p. A-8) attached hereto. We are informed and believe that even this $6 billion figure does not include the tripling of special overriding royalties on June 1, 1985 that the producers may seek under the 1974 settlement agreement.

GLA properties to Tenneco and Conoco. In addition, under the proposed settlement El Paso would amend approximately 100 other San Juan Basin gas purchase contracts with Tenneco and Conoco and would transfer all of its liquids revenues from those properties (which were not even part of this litigation) from ratepayers to Tenneco and Conoco. Additionally, with the producers' incentive to extract as much liquids as possible, the gas they supply to El Paso will contain less Btus, further threatening future gas supplies, and much of this gas is low-cost old gas which would have to be replaced, if it can be, by more expensive new gas. Through discovery we could learn the full amounts and impacts involved. In view of the fact that these producers settled with El Paso at a time when they had the most leverage over El Paso, and that they deliberately excluded all of the other petitioners from these negotiations, we have reason to believe that this impact could be enormous.

Unless this Court grants certiorari and reverses the decision of the court below, western states ratepayers face dismal alternatives. Absent a jurisdictional finding by this Court, El Paso has represented that it will seek from the Commission special relief to pass onto its customers (and ratepayers) the exorbitant costs it must pay to the *unregulated* producers. On the other hand, if El Paso's proposed settlements with certain producers are approved by the Commission, El Paso's customers and ratepayers still face substantial rate increases and risk a curtailment in their future gas supply. Moreover, these settlements do not apply to all of El Paso's or Northwest's gas produced under the GLAs and PLAs.[5]

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[5]El Paso has not settled with producers of 15% of its gas in question. We are informed and believe that Northwest, which is in a similar predicament as El Paso, has not settled with producers of over 25% of the gas it receives under its Pacific Lease-Sale Agreements ("PLAS") and its special overriding royalties could more than double on June 1, 1985.

El Paso, Northwest, their customers and the western states ratepayers are entrapped in a no-win situation due to the producers' current success in escaping from the regulations which Congress intended to govern wholesales of interstate gas. Unless this Court reviews this matter and reverses the decision below, the Commission is relatively powerless to prevent this exploitation, and the pipeline companies, their customers, and the western states ratepayers are at the mercy of the producers.

IV

CONCLUSION

For the foregoing reasons, this Court should grant the petitions for writs of certiorari.

Dated: June 12, 1984

Respectfully submitted,

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(Appendices follow)

Appendix A

United States of America
Federal Energy Regulatory Commission

Hearing

Before Commissioners: Raymond J. O'Connor, Chairman;
Georgiana Sheldon,
J. David Hughes, A. G. Sousa
and Oliver G. Richard III.

Union Oil Company of California Docket No. CI84-141-000
Order Providing for Hearing

(Issued May 10, 1984)

Union Oil Company of California (Union) has filed an application for a certificate of public convenience and necessity authorizing Union to sell gas to El Paso Natural Gas Company (El Paso) from its interest in certain leases in the Basin Dakota, Mesa Verde Blanco, South Blanco and Ballard Pictured Cliffs Fields, San Juan and Rio Arriba Counties, New Mexico. El Paso is the predecessor in interest to the properties from which the sale will be made.

Union's application follows an agreement to settle certain disputes between El Paso and Union regarding their future relationship with respect to the leases in question. These disputes initially involved the level of overriding royalties payable to Union under three lease agreements (GLAs 76, 348 and 349) entered into in 1953 and 1958. The court recently held that these lease agreements, among others, were not subject to this Commission's jurisdiction under the Natural Gas Act.[1] El Paso thus remained obli-

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[1] *El Paso Natural Gas Co. v. Sun Oil Co.*, 708 F.2d 1011 (5th Cir. 1983). A petition for a writ of certiorari was filed with the United States Supreme Court by the Commission on April 2, 1984, in *FERC v. Tenneco Oil Company, et al.*

gated under the 1974 amendments to the three lease agreements to pay Union an overriding royalty equal to the highest price of general applicability in the San Juan Basin area less seven cents per Mcf. Since passage of the Natural Gas Policy Act of 1978 (NGPA), El Paso has interpreted these amendments as entitling Union to collect for its overriding royalty interest the NGPA Section 102 price less seven cents per Mcf. This interpretation has been applied by El Paso, even though El Paso, itself, may be limited for gas produced from some of the properties to prices below the Section 102 price.

Following the decision in *Public Service Commission v. Mid-Louisiana Gas Co.*, 51 U.S.L.W. 5030 (June 28, 1983), where the Court held that gas produced by a pipeline is subject to the first sale pricing provisions in the NGPA, El Paso sought to convey the properties covered by the three lease agreements to Union. El Paso also filed a petition for declaratory order in the District Court of Harris County, Texas, naming Union as a defendant, as well as other producers who had overriding royalties in other lease agreements.[2] El Paso claimed there that the *El Paso* and *Mid-La* decisions had made the wells on the properties in question unprofitable to operate and non-commercial and attempted to invoke provisions in GLA 76 that allegedly empowered it unilaterally to reassign these wells to Union effective October 1, 1983.[3] In response Union denied El Paso's right unilaterally to reassign the wells.

El Paso also filed a petition with this Commission in Docket No. CI83-356-000 requesting, *inter alia*, an order

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[2]*El Paso Natural Gas Co. v. Tenneco Oil Co., et al.*, Docket No. 83-50539. In a memorandum opinion issued February 15, 1984, the Court denied El Paso's petition.

[3]GLAs 348 and 349 do not contain such a provision, and with respect to these agreements El Paso tendered reassignment, subject to Union's acceptance.

requiring Union to seek certificate authorization for the sale by Union to El Paso of gas produced from the properties it had allegedly reconveyed. Union in its petition to intervene in that case denied El Paso's right unilaterally to reassign any of the properties and contended that it was not required to seek a certificate.

Union and El Paso on November 11, 1983, resolved their dispute concerning reassignment of the subject properties. They have agreed that upon receipt of a certificate satisfactory to Union authorizing it to sell gas to El Paso, Union will accept voluntarily reassignment of the properties effective as of October 1, 1983. As a result of the settlement, Union was dismissed as a defendant in the Harris County litigation.

The gas purchase agreement which will govern the sale of gas by Union to El Paso covers gas produced from Union's interests in the subject properties. It requires El Paso to take or pay for on an annual basis 50% of Union's deliverability, but in no case less than ratably with other producers in the area. The agreement further provides that El Paso shall pay the maximum lawful price applicable to the gas under the NGPA, except that for gas subject to NGPA Section 107(c)(5), the price shall not exceed the NGPA Section 102 ceiling.

Union states that it will charge the NGPA Section 108 price for stripper well gas and the NGPA Section 102 price for gas qualifying under NGPA Section 107(c)(5). For the remainder of the gas Union claims the right to charge the ceiling prescribed in NGPA Section 109. As to such gas Union asserts that it was committed or dedicated to interstate commerce prior to the enactment of the NGPA but was not subject to a just and reasonable rate set by the Commission.

After due notice by publication in the *Federal Register* on December 29, 1983 (48 Fed. Reg. 57364), timely petitions

to intervene were filed by Southern California Gas Company (So Cal), Pacific Gas and Electric Company (PG&E), The People of The State of California and The Public Utilities Commission of The State of California (California), El Paso Natural Gas Company (El Paso), Southern Union Gas Company, Gas Company of New Mexico, Southwest Gas Corporation (Southwest) and Tenneco Oil Company, Conoco Inc., *et al.*[4] An untimely petition was filed by Northwest Pipeline Corporation (Northwest). Good cause exists to grant Northwest's petition to intervene in the instant proceeding.

So Cal, PG&E, California, and Southwest in their petitions have indicated disagreement with Union's position that it is entitled to the NGPA Section 109 price. So Cal, PG&E and California have requested a formal hearing. PG&E, as a possible alternative, has suggested an informal conference. El Paso in its petition takes no position with respect to Union's price, but it does suggest that if the price becomes a disputed issue, it would involve a question of law which can best be addressed by the submission of written arguments.

In addition to the Section 109 price question, there is also a need to resolve one other issue before any certificate can be issued to Union. Specifically, the various provisions in the settlement between El Paso and Union concerning the transfer of the subject properties should be explored in this certificate case. While the settlement has not been submitted to this Commission for its approval, we think it important for us to ascertain how the settlement affects El Paso's customers and whether it is in the public interest to grant Union authorization in light of the settlement provisions.

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[4]These interventions have been granted by operation of Rule 214.

The transfer of the subject properties to Union may constitute a change in the service previously rendered by El Paso. Union's application should, therefore, be evaluated in the context of not only the changes on Union but also the types and extent of changes on El Paso. If Union is to be authorized to acquire the properties and sell gas from the properties, a satisfactory showing of consistency with the overall public interest will be required. This is important because a satisfactory showing made in this subject proceeding would constitute a presumption of prudence in implementing the provisions of the settlement in El Paso's jurisdictional rates. In this regard, Union and El Paso shall be required to demonstrate that the settlement provisions are in the public interest. In addition, Union shall make the settlement a part of the record in this case.

In view of the foregoing, it is necessary to set this matter for hearing. Because of the complex nature and certain unique features of the application, the Commission believes that a prehearing conference involving all the parties and the staff should be convened at an early date. The express purpose of that conference would be for delineating issues of concern by the various parties and determining issues which may be resolved by agreement and issues which may require legal briefing or formal hearings.

Union has suggested in its certificate application that there is no need to resolve herein the question of whether El Paso should obtain abandonment authorization under Section 7(b) of the Natural Gas Act before it reassigns the properties to Union. We agree. Union has voluntarily agreed to the reassignment and has applied for certificate authorization. El Paso is an intervenor in this case and will be required to show that the settlement with Union is in the public interest. The Commission will thus have available all of the information necessary to determine whether Union's proposed sale is required by the present or future public convenience and necessity.

The Commission finds:

The public interest requires that this case be set for formal hearing.

The Commission orders:

(A) Pursuant to the authority of the Natural Gas Act, particularly Sections 4, 5, 7, 8, 14, 15, and 16, and the Commission's rules and regulations, a public hearing shall be held in the above-entitled proceeding.

(B) A Presiding Administrative Law Judge shall be designated by the Chief Administrative Law Judge (18 C.F.R. § 385.304), to preside over this proceeding in a hearing room of the Federal Energy Regulatory Commission, 825 North Capitol Street, N. E., Washington, D. C. 20426. A prehearing conference shall be convened at an early date for the express purpose of delineating issues of concern by the various parties and determining issues which may be resolved by agreement and issues which may require briefing or formal hearings. The Presiding Administrative Law Judge is authorized to establish such further proceedings in accordance with this order and the Rules of Practice and Procedure.

(C) Northwest is permitted to intervene in this proceeding subject to the rules and regulations of the Commission; *Provided,* however, that the participation of such intervenor shall be limited to matters affecting asserted rights and interests as specifically set forth in its petition to intervene; and *Provided, further,* that the admission of said intervenor shall not be construed as recognition by the Commission that it might be aggrieved because of any order of the Commission entered in this proceeding.

By the Commission.

(SEAL)

/s/ Kenneth F. Plumb
Kenneth F. Plumb,
Secretary.

Appendix B

Houston Post,
March 1, 1984, p. 1F

El Paso
to appeal
gas case
By Sam Fletcher
Post Energy Writer

El Paso Natural Gas Co. said Wednesday it plans to appeal its loss in an unique natural gas case described as the largest ever tried.

The ruling involves royalty payments which some say would amount to $6 billion over a 20-year period and $2 million in attorneys' fees for the 84 winning defendants.

Judge William N. Blanton Jr. of the 11th District Court of Harris County entered final judgment Wednesday denying El Paso's efforts to transfer ownership of natural gas leases in an effort to avoid those royalty payments which company officials said made those wells unprofitable.

3,200 wells

Involved were 3,200 wells in the San Juan Basin of New Mexico.

Robert J. King of Liddell, Sapp, Zively, Brown & LaBoon, the law firm representing El Paso, said the company filed the suit in 1983 against Tenneco Oil Co., Conoco Inc. and other defendants because it is losing $50 million a year on production from those leases.

King said the controversy began with a June 1983 ruling by the Supreme Court which for the first time applied the same federal price limitations on gas wells owned and operated by pipeline companies as those wells not owned by pipelines.

Because the series of contracts involving the San Juan Basin leases date back to 1952-1953, King said, some of that gas is priced at 85 cents per thousand cubic feet (Mcf) with the remainder in the range of $2.50 Mcf.

However, he said, the contracts provide for overriding royalties amounting to $3.25 per Mcf to be paid to the defendants. Because the company couldn't sell its gas for as much as the overriding royalties, he said, El Paso is losing $50 million annually.

"If the gas bubble disappears and production increases, the corresponding loss could approach $100 million a year," he said.

For that reason, he said, El Paso filed suit last August seeking relief under a provision of the contracts which allowed it to turnback unprofitable wells.

"The company thought it could give the properties back to the clients to eliminate having to pay royalties, and then purchase the gas from them at the regulated price," said Diana E. Marshall, a partner at Baker & Botts who represented most of the defendants, including Tenneco and Conoco.

She said those royalties would total about $6 billion over a period of 20 years.

Amounts not considered

In his ruling, Blanton said the lease sale agreements do not take into account the amounts of either royalties or gas prices in determining the profitability of a well.

"He construed the contract language to mean that the wells are not unprofitable in the normal sense," King said. "The judge only looked at the operational costs."

King said the wells, which are dedicated to interstate markets primarily in Arizona and California, will continue

producing. He said, "It is one of the most substantial gas fields in the nation."

Because of the unique nature of this case, both sides said it will have no impact on other natural gas contracts or prices.

"We're told this is the largest case ever tried," Marshall said. "Other suits may have been filed that initially asked for more money, but this is supposed to be the biggest amount of money and controversy ever disposed of by a trial judge."

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FILED
JUN 8 1984
ALEXANDER L. STEVAS,
CLERK

No. 83-1321, 83-1432, 83-1433,
83-1442, 83-1443 & 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

On Petitions For Writs Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

SUPPLEMENTAL MEMORANDUM OF PETITIONER EL PASO NATURAL GAS COMPANY WITH RESPECT TO SETTLEMENTS BETWEEN THE PARTIES

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SUPPLEMENTAL MEMORANDUM OF PETITIONER EL PASO NATURAL GAS COMPANY WITH RESPECT TO SETTLEMENTS BETWEEN THE PARTIES

By letter dated May 31, 1984, the Clerk of the Court advised all counsel in the proceedings captioned above of the Court's direction that counsel be provided with the opportunity of filing a supplemental memorandum discussing the offer of settlement and joint request for approval of stipulation of settlement agreement that was filed with the Federal Energy Regulatory Commission ("FERC") on May 18, 1984, and commenting upon any other agreed upon settlement between parties to these cases which might have bearing upon the pending petitions for writs of certiorari.

Petitioner El Paso Natural Gas Company ("El Paso") welcomes the opportunity to lay to rest any questions which might exist with respect to the relationship between certain settlements to which it is a party and the cases now pending before the Court on petitions for writs of certiorari, and accordingly files this supplemental memorandum.

I. Status of Settlements

On November 11, 1983, El Paso entered into a settlement agreement with Union Oil Company of California ("Union").[1] A brief description of the settlement is set forth in Appendix A *infra*. Pursuant to the settlement agreement, Union filed with the FERC in Docket No. CI84-141 an application for those Commission authorizations necessary to implement the settlement. By order issued May 10, 1984, the Commission directed that a hearing be held on issues raised by the gas sale authorizations sought by Union, and a prehearing conference has been scheduled before an Administrative Law Judge on June 20, 1984.

On May 9, 1984, El Paso entered into a Stipulation of Settlement and Agreement with Tenneco Oil Company ("Tenneco") and Conoco Inc. ("Conoco"). A brief description of the settlement between El Paso and Tenneco and Conoco is set forth in Appendix B, *infra*. On May 18,

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[1] The settlement agreement provides that either party may terminate the agreement if Union did not receive requisite FERC authorizations by April 1, 1984. Such authorizations were not received, and thus either party to the agreement is free to terminate the agreement at this time. El Paso and Union are in the process of discussing and negotiatiating amendments to their settlement in light of the May 9, 1984 settlement reached between El Paso, Tenneco, and Conoco.

1984, a joint "Offer of Settlement and Agreement" was filed by El Paso, Tenneco, and Conoco with the FERC. On May 30, 1984, the Commission noticed the Offer of Settlement and related applications and has provided that any party desiring to file comments with respect to the Offer of Settlement should, on or before July 2, 1984, file such comments with the Commission; the Commission has also provided that reply comments are due to be filed on or before July 12, 1984.

II. Relationship Between the Settlements and the Cases Pending Before the Court

Neither the Union nor the Tenneco/Conoco settlement disposes of the GLA jurisdictional issue presented to the Court in the pending petitions for a writ of certiorari. Neither settlement renders the matters before the Court moot, in whole or in part. Neither settlement is intended or structured to affect the Court's decision to grant or deny the petitions for certiorari.

It is critical that the Court, and all parties to these cases, understand that neither settlement is self-executing as between the settling parties. Affirmative action by the FERC is required—after appropriate Commission review and consideration of the public interest, the public convenience and necessity, and the reasonableness of the proposed settlement arrangements—before the settlement arrangements can be fully effectuated.

El Paso advises the Court that the proposed settlement arrangements do not terminate any case now pending before the Court, do not dispose of the GLA/PLA jurisdictional issue presented in the pending petitions for writs of certiorari, and do not in any manner lessen the

importance of the Court's grant of the petitions and reversal of the judgments of the United States Court of Appeals for the Fifth Circuit.

What, then, is the purpose of the settlement agreements, if they do not terminate the issues between the settling parties? Even a casual reader of the record will comprehend fully that when the GLA jurisdictional issue presented in these cases is laid to rest by this Court, there will remain—without regard to whether the Fifth Circuit is affirmed or reversed—extraordinarily complex regulatory, economic, and operational questions that, if left to further litigation, may take years for final resolution. El Paso has attempted, therefore, to arrive at an appropriate resolution of all these issues through comprehensive settlement. El Paso believes that the settlement arrangements provide a reasonable, prudent, public interest resolution of a broad spectrum of issues that must be resolved irrespective of the Court's decision on the merits of these cases.

In El Paso's judgment, this is neither the time nor the forum in which to litigate the merits of the settlement proposals. Whether or not El Paso is correct in its assessment that the settlement is in the public interest must necessarily await a full review by the Commission of the totality of the settlement arrangements, which resolve issues of gas supply, gas contracting, gas pricing, natural gas liquids processing, and gas gathering and transportation. The settlement arrangements will stand or fall, dependent upon the Commission's assessment of the settlement arrangements in the light of the public interest as found and determined by the Commission.

Most importantly, it is obvious that the Commission's determination of where the public interest lies will be affected by whether the lease sales are jurisdictional sales as contended in the petitions for certiorari. It is therefore of paramount importance that this Court finally resolve the merits of the jurisdictional issue presented by the petitions. Once the jurisdictionality of the GLA transactions is determined by this Court, there will be a clear standard by which the settlement arrangements can be tested for the traditional regulatory criteria of prudence, justness, reasonableness, and public convenience and necessity. Until this is done, it will be difficult, if not impossible, for the Commission and all affected parties to gauge whether the settlement arrangements are appropriate, in the public interest, and deserving of all necessary Commission authorizations and approvals. The proposed settlement arrangements underscore the need for the Court's prompt determination of the jurisdictionality of the GLA transactions. Indeed, this Court could best serve the public interest by summarily reversing the judgments below, as requested in El Paso's petition.

III. Conclusion

El Paso strongly endorses the granting of certiorari to review the patently erroneous decision below. El Paso concurs in the statement of the Solicitor General in the Reply Memorandum for the Petitioner, p. 6, that ". . . we submit that the future ramifications of this one case alone are themselves sufficiently substantial to warrant certiorari." The filing of the proposed settlement arrangements[2] in no way alters the accuracy of this statement.

Respectfully submitted,

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[2] El Paso has not reached settlements with Atlantic Richfield Co., Sun Oil Co., and other producers. Hence, the pending settlements if approved do not stop the excessive payments that El Paso makes to these producers.

APPENDICES

APPENDIX A

The El Paso/Union Settlement

The November 11, 1983 Settlement Agreement between El Paso and Union provides for the following:

A. El Paso will reconvey to Union the interests in GLA's 76, 348 and 349 which El Paso acquired from Union's predecessor in interest.

B. After reconveyance, Union will sell gas produced from the reassigned interest pursuant to the terms of a gas purchase contract attached to the Settlement Agreement. In pertinent part, the Gas Purchase Agreement establishes the following terms and conditions:

1. Price: maximum lawful price as permitted under the Natural Gas Act or the Natural Gas Policy Act of 1978, except that NGPA Section 107 incentive regulated gas shall be priced at the NGPA Section 102 applicable monthly price.
2. Term: two years, plus guaranteed renewals for a second term of three years, and a third term of five years.
3. Coverage: all gas produced from the reassigned GLA properties.
4. Market-out: El Paso in its sole discretion, subject only to non-discriminatory application systemwide where similar market-out rights exist, can lower the price otherwise payable to that price which represents the value to El Paso of the gas to be purchased.
5. Take-or-pay: 50 percent or daily stabilized producing capacity, subject to regulation by government authority or force majeure intervention.
6. Processing rights: If El Paso processes Union's gas, El Paso shall receive 23 percent of the liquids as a processing fee.

7. Reservations: Union reserves to itself 25 percent of the gas produced from the reassigned acreage from wells commenced subsequent to the date of first deliveries under the Gas Purchase Agreement.

8. Transportation: El Paso will transport the reserved gas, if requested, charging a transportation fee corresponding to that fee charged for similar services under other agreements at the time such right is exercised.

C. If El Paso notifies Union on or before April 1, 1985 that it proposes to construct a new natural gas processing plant in the San Juan Basin, El Paso's processing fee of 23 percent shall be renegotiated.

D. If by April 1, 1985 El Paso and Union have not reached agreement with respect to a new gas processing plant, Union shall have the option to arrange separately for the processing of gas produced from its properties and sold to El Paso.

E. If El Paso should resolve by settlement with either Tenneco or Conoco its presently outstanding dispute regarding GLA 47, on a basis which includes the execution and implementation of a gas purchase agreement, Union shall have the option to be exercised within 45 days after the effectiveness of such gas purchase agreement to supersede prospectively the gas purchase agreement between El Paso and Union with a gas purchase agreement in form and substance identical to that entered into between El Paso and either Tenneco or Conoco.

F. Immediately upon execution of the settlement agreement, appropriate pleadings will be prepared and filed by Union with the FERC seeking (1) all requisite certificate authority to sell and deliver natural gas to El Paso from wells subject to the FERC's certificate author-

ity pursuant to the terms and conditions of the gas purchase agreement, (2) acceptance of the gas purchase agreement as Union's initial rate schedule, and (3) FERC determination of applicable NGPA prices.

G. In the event Union has not received a FERC certificate and acceptance by the FERC of the gas purchase agreement as Union's initial rate schedule on or before April 1, 1984, either Union or El Paso shall have the right upon written notice to the other to terminate the settlement agreement.

H. If the FERC's certificate and rate schedule orders impose a condition repugnant and unacceptable to Union, it may reject the proferred certificate authority and may cancel the agreement.

I. El Paso and Union agree to amend certain existing gas purchase agreements between them with respect to gas produced and sold from non-GLA acreage, the amendatory agreements being attached to the settlement agreement.

J. For the period of time from October 1, 1983 and ending on the earlier of (a) the date upon which Union accepts all requisite authorizations issued by the FERC regarding the sale and delivery by Union to El Paso of natural gas produced from the reassigned properties or (b) the 91st day after Union's rejection of unsatisfactory FERC authorizations, or (c) the 91st day after either Union or El Paso has duly elected to terminate the settlement agreement, overriding royalty payments are to be made by El Paso to Union on the basis of the applicable first sale maximum lawful price established by the Natural Gas Policy Act of 1978 (but in no event less than the NGPA Section 104 "replacement" rate) less seven cents per Mcf.

K. El Paso and Union agree to execute a motion for submission to the Court in Harris County, Texas in El Paso Natural Gas Company v. Tenneco Oil Company, *et al.* No. 83-50539, dismissing without prejudice Union as defendant in El Paso's declaratory judgment action and dismissing without prejudice Union's counterclaims against El Paso.

APPENDIX B

The El Paso-Tenneco-Conoco Settlement

The Stipulation of Settlement and Agreement between El Paso, Tenneco, and Conoco dated May 9, 1984 and filed with the FERC on May 18, 1984 provides as follows:

A. The Settlement will not become effective until (1) an order of the FERC approving the Offer of Settlement, the Stipulation of Settlement and all operative agreements and issuing all certificates, approving all abandonments within its jurisdiction, and granting all other authorizations that are necessary to implement the Settlement Agreement and permit performance of every operative agreement sought by the parties hereto has issued; (2) such order has become final and no longer subject to judicial review; and (3) such order has been found by each of El Paso, Tenneco, and Conoco to be acceptable to it.

B. Tenneco and Conoco jointly have the option to effect a reassignment of the GLA properties and become conventional sellers while the settlement is before the Commission, but if they so elect, however, their status as conventional sellers will be prospective only, effective upon the grant of necessary sales authorizations from the Commission, and all remedies of all parties as to periods prior to the producers' assumption of status as conventional sellers will be resolved in the event of a jurisdictional decision by this Court through future Commission proceedings.

C. El Paso will reconvey to Tenneco and Conoco the interests in GLA's 47, 52, 60, and 78 which El Paso acquired from the predecessors in interest of Tenneco and Conoco.

D. Tenneco and Conoco will each become conventional sellers of natural gas under gas purchase con-

which contracts establish the following terms and conditions:

1. Price: NGPA prices for §§ 102, 103, 107, 108 gas; $2.00/MMBtu for all other gas through June 30, 1986, reduced on July 1, 1986 to § 106(a) NGPA price level.

2. Term: 20 years.

3. Coverage: all GLA gas, with Tenneco/Conoco to have option to add all presently undedicated San Juan leases to the contract.

4. Market-out: El Paso in its sole discretion, subject only to non-discriminatory application systemwide where similar market out rights exist, can reduce the applicable price to that level which represents the value of the gas to El Paso. Upon an El Paso price reduction, Tenneco/Conoco can withdraw marketed-out gas if abandonment is not required.

5. Reservations: Tenneco/Conoco each reserves 25% of the gas produced from the re-assigned interests, if the reserved gas is not subject to the abandonment requirements of the Natural Gas Act.

6. Transportation: El Paso will transport market-out and reserved gas, subject to receipt of regulatory approvals.

7. Take-or-pay: 60%, both contracts, for 2 years. 75% as to Tenneco, 74.4% as to Conoco thereafter. Take-or-pay limited to state allowables. Full make-up rights for five years, refund in full if not made up.

8. Processing Rights: Tenneco/Conoco have all processing rights. Tenneco/Conoco bear all plant fuel and shrinkage.

E. Liquids extractions will be governed by agree-

ments covering all liquids arrangements, which provide for:

1. El Paso processes Tenneco/Conoco gas in El Paso's existing plants until a new cryogenic plant is built. El Paso will take 23% of the liquids as its fee for five years, and 28% after five years.

2. Tenneco/Conoco will build the new plant on a site provided by El Paso at its Blanco plant site, and upon completion will process their own gas and El Paso's. Tenneco/Conoco will take 39% of the liquids as their fee. The new plant will have a nominal design capacity of 500 MMcf/day.

3. The new plant will become the San Juan Basin base load plant, but all El Paso plants other than old Blanco will remain on stream.

4. El Paso will undertake to keep the new plant at nominal design capacity by delivering gas to fill capacity after Tenneco/Conoco volumes are delivered.

5. Tenneco/Conoco will install, at their sole cost, at least 10,000 H.P. of secondary compression in the new plant; El Paso will idle a reciprocating compressor now in operation.

F. Upon approval by the FERC of the settlement by final order no loner subject to judicial review, Tenneco and Conoco will each pay to El Paso $25 million, and El Paso will flow-through this $50 million settlement fund to its rate-payers in accordance with a Commission-approved plan.

G. After Commission approval of the settlement by final order no longer subject to judicial review, El Paso, Tenneco, and Conoco shall file with theSupreme Court a suggestion of mootness to reflect that a full and final settlement as between these parties has been reached. Such filing would be made in the event that the final

FERC approval not subject to judicial review preceeded this Court's decision on the merits if certiorari is granted.

H. During the pendency of the settlement before the Commission, neither El Paso, Tenneco, or Conoco will initiate new litigation with respect to GLA issues; each party retains the full right, however, to take such actions in existing or future cases as are necessary to preserve its procedural and substantive rights.

I. The Settlement Agreement may be terminated at any time prior to its effective date by mutual written consent of El Paso, Tenneco, and Conoco; by Tenneco and Conoco if the conditions precedent to the effectiveness of the settlement have not been satisfied within the earlier of (1) fifteen months after the date of execution of the Agreement or (2) 180 days after the date of a final order denying certiorari in the cases now pending before the Court; by El Paso if the conditions precedent to the effectiveness of the Agreement have not been satisfied within the earlier of (1) 15 months after the date of execution of the Settlement Agreement or (2) 30 days after the date of the final Decision of the Supreme Court of the United States reversing the Decision of the United States Court of Appeals for the Fifth Circuit in the pending Causes.

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Nos. 83-1321, 83-1432, 83-1433, 83-1442,
83-1443, and 83-1618

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, et al.,
Petitioners,

VS.

TENNECO OIL COMPANY, et al.,
Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

JOINT SUPPLEMENTAL MEMORANDUM OF PETITIONERS PACIFIC GAS AND ELECTRIC COMPANY, SOUTHERN CALIFORNIA GAS COMPANY, AND SOUTHWEST GAS CORPORATION

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JOINT SUPPLEMENTAL MEMORANDUM OF PETITIONERS PACIFIC GAS AND ELECTRIC COMPANY, SOUTHERN CALIFORNIA GAS COMPANY, AND SOUTHWEST GAS CORPORATION

Pacific Gas and Electric Company, Southern California Gas Company, and Southwest Gas Corporation ("Petitioners"), Petitioners in Cases No. *83-1443* and *83-1433*, respectively, jointly file this supplemental memorandum pursuant to the Clerk of the Court's letter of May 31, 1984, to submit their comments on the offers of settlement and settlements between certain parties to these cases.[1]

[1]Southwest Gas Corporation (Southwest) purchases gas from El Paso Natural Gas Company (El Paso) for resale in Southwest's Southern Nevada Division and Arizona Division distribution areas. Southwest also purchases gas from Northwest Pipeline Corporation (Northwest) for resale in its Northern Nevada Division distribu-

The Clerk's letter permits the parties to comment on the offer of settlement and joint request for approval of stipulation of settlement and agreement filed by Tenneco Oil Company ("Tenneco"), Conoco Inc. ("Conoco") and El Paso Natural Gas Company ("El Paso") with the Federal Energy Regulatory Commission ("FERC") on May 18, 1984.[2] Comments are also requested on other settlements between parties to these cases that might have a bearing upon the pending petitions for writs of certiorari. El Paso has entered into one other offer of settlement with Union Oil Company ("Union") involving the gas lease agreements (GLAs) at issue here.[3] [4]

Neither the Tenneco-Conoco offer of settlement nor the Union offer of settlement lessens the importance of this Court's decision on the petitions for writ of certiorari to the future cost and supply of gas from the San Juan Basin. The Tenneco-Conoco and Union offers of settlement would, if implemented, have continuing serious adverse effects on

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tion area. For that reason Southwest has joined with El Paso's two largest customers in this supplemental memorandum on behalf of its Southern Nevada and Arizona Divisions, and has also joined, on behalf of its Northern Nevada Division, in a supplemental memorandum filed by Northwest and its customers.

[2]Hereafter described as the "Tenneco-Conoco offer of settlement".

[3]Hereafter described as the "Union offer of settlement". The gas purchase contract which was negotiated by Union and El Paso as part of the Union offer of settlement was filed with the FERC on December 13, 1984. (Docket No. CI-84-141-000).

[4]Northwest has entered into settlement agreements with two of its lease holders, Phillips Petroleum Company ("Phillips") and Getty Oil Company ("Getty"). The Phillips and Getty settlements are identical to each other in all major respects. ("Northwest settlements"). There are major differences, however, between the Northwest settlements and both the Tenneco-Conoco and Union offers of settlement with El Paso. Generally, the Tenneco-Conoco and

the cost and supply of gas for Petitioners and the millions of customers they serve throughout California, Arizona and Nevada.[5] The only protection available to consumers is the regulatory power of the FERC over the offers of settlement and the underlying gas lease agreements, but the ability of the FERC to protect effectively the public interest is dependent upon this Court's decision as to whether the FERC has jurisdiction over the gas lease agreements. Unless this Court grants certiorari and reverses the decision below, the FERC's power to reject the offers of settlement will not be adequate to protect the public interest.

I

TENNECO, CONOCO, UNION AND EL PASO HAVE THE ABILITY TO WITHDRAW THE OFFERS OF SETTLEMENT

The Tenneco-Conoco and Union offers of settlement are merely offers and may be withdrawn by Tenneco, Conoco, Union and El Paso under certain conditions. The Union offer of settlement allows either Union or El Paso to walk away from the offer if satisfactory FERC approval was not obtained by April 1, 1984. FERC approval has not been given and the case is set for a prehearing conference on

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Union offers of settlement compare unfavorably from a consumer viewpoint with the Northwest settlements. PGandE and Southern California Gas Company opposed the Phillips settlement as insufficiently protective of consumer interests, but did not file comments on the Getty offer of settlement.

[5]Pacific Gas and Electric, Southern California Gas Company and Southwest Gas Corporation are not parties to either the Tenneco-Conoco or the Union offers of settlement. None of the Petitioners was involved in the negotiations for either offer of settlement. None of the Petitioners learned about the offers of settlement until Tenneco, Conoco and Union had finalized their respective offers of settlement with El Paso.

June 20. Consequently Union and El Paso are both free to withdraw their offer of settlement at any time. The Tenneco-Conoco offer of settlement may be withdrawn (a) by either side if final FERC approval in a satisfactory form has not issued in 15 months after the date of execution, (b) by Tenneco-Conoco if such final approval is not issued within 180 days following denial of certiorari in this case, and (c) by El Paso if such final approval has not issued within 30 days following the final reversal of the Fifth Circuit decision on appeal herein.

These withdrawal provisions allow Tenneco, Conoco and Union to abandon their offers of settlement if satisfactory FERC approval, based on their sole discretion, is not received within specified time periods.[4] Since the offers of settlement may be withdrawn, the Court should not deny certiorari in the belief that this case will be settled. If the petitions for certiorari are not granted, the FERC and El Paso's customers will be left with two disastrous choices: (1) accept the offers of settlement with their generous concessions to Tenneco, Conoco and Union, or (2) face withdrawal of the offers and risk further escalation of gas prices to levels far above the applicable rates under the Natural Gas Policy Act of 1978 ("NGPA") or loss of a vital gas supply. In contrast, if the petitions for certiorari are granted and FERC jurisdiction is found to exist, the FERC and El Paso's customers would not be limited to this draconian "take it or leave it" choice, but instead would

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[4]In contrast to the Tenneco-Conoco and Union offers of settlement which have not been approved by the FERC and can be withdrawn, the Phillips and Getty settlements with Northwest have been approved by FERC and cannot be withdrawn.

be able to review and question the offers of settlement with the knowledge that the FERC could order a resolution that would protect the public interest.

II

THE TENNECO, CONOCO AND UNION OFFERS OF SETTLEMENT DO NOT ALTER THE FACT THAT TREMENDOUS AMOUNTS REMAIN AT STAKE IN THIS APPEAL

A brief review of the offers of settlement confirms the fact that tremendous amounts remain at stake in this case. The offers of settlement are extremely complex and require considerable further analysis and discovery. However, by transferring the benefit of natural gas liquids to Tenneco, Conoco and Union while nominally basing the gas prices on NGPA rates, the offers of settlement continue to give Tenneco, Conoco and Union much greater economic benefits than Petitioners believe they are entitled to receive. Moreover, the offers of settlement would have a significant adverse effect on the gas supply available from the San Juan Basin to El Paso customers.

The Tenneco-Conoco offer of settlement changes the basis for the price of gas from the NGPA § 102 rate for new natural gas to the applicable maximum lawful prices for all vintages of gas except gas production from pre-1973 wells ("old gas").[7] With respect to the old gas for which the rate should be less than $1 per MMBtu, the offer of settle-

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[7]Under the Tenneco-Conoco offer of settlement, high incentive prices would be charged for NGPA § 108 stripper well gas production and NGPA § 107 gas production from tight formations. The NGPA § 108 and § 107 prices are approximately $3.97 per MMBtu and $5.80 per MMBtu, respectively.

ment sets the price at $2.00 per MMBtu, escalated for inflation through June 30, 1986.[8] After June 30, 1986, gas subject to the $2.00 price would go to the NGPA § 106(a) price which is also higher than the applicable NGPA § 104 price.[9] Similarly Union has claimed the NGPA § 109 price for gas production from pre-1973 wells which is more than $1.50 higher than the applicable old gas rate.[10] In effect, Tenneco, Conoco and Union are agreeing to NGPA maximum prices for categories of gas that are relatively expensive, but for older gas that should be much less expensive, they are seeking prices far in excess of the NGPA rates which Petitioners believe should apply.[11]

The gas prices reflected in the Tenneco, Conoco and Union offers of settlement would be implemented in new gas purchase contracts between El Paso and Tenneco, Conoco or Union. Theoretically the rates paid for the gas would

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[8]Gas from pre-1973 wells is subject to NGPA § 104 or NGPA § 106(a) pricing. The current NGPA § 104 flowing gas price is approximately $.49 per MMBtu.

[9]Currently the NGPA § 106(a) price is approximately 89¢ per MMBtu.

[10]Currently the NGPA § 109 price is approximately $2.40 per MMBtu.

[11]The gas prices stated in the Tenneco-Conoco and Union offers of settlement compare unfavorably with the Northwest settlements. In the latter agreements, no gas will be priced at the Section 107 incentive rate. Moreover, old gas from pre-1973 wells will be priced at the Section 104 replacement contract gas rate of approximately $.87 per MMBtu. If the FERC is found to have jurisdiction over the overriding royalties, however, the Northwest settlements reduce the price of gas from pre-1973 wells to the Section 104 flowing gas rate of approximately $.49 per MMBtu, provided the FERC determines that the Section 104 flowing gas rate is the appropriate ceiling price for such gas.

then be subject to the FERC's regulatory power. However, without jurisdiction over the gas lease agreements, the FERC's regulatory power would be illusory. If certiorari is denied, any action by the FERC rejecting the Section 109 rate or the $2.00 price for old gas would simply cause Tenneco, Conoco and/or Union to walk away from the offers of settlement. They would then continue collecting overriding royalties at current high levels. So the new gas purchase contracts that would be created under the offers of settlement do not lessen the need for this Court to grant the petitions for certiorari in any way.

The disposition of natural gas liquids under the Tenneco-Conoco and Union offers of settlement is extremely undesirable from the Petitioners' and gas consumers' viewpoint. The liquids removed from natural gas are quite valuable. Under the present gas lease agreements, Tenneco, Conoco and Union receive one-third of the liquids from the properties at issue, while El Paso retains two-thirds of the liquids. For many years, the revenues received from El Paso's sale of two-thirds of the liquids has been flowed through to gas consumers. Now, for the first time in the Tenneco-Conoco and Union offers of settlement, El Paso is surrendering the consumers' share of the liquids to Tenneco, Conoco and Union and depriving the consumers of their liquid credits from these properties.[12] In addition, El Paso has even agreed to give Tenneco and Conoco the consumers' share of liquids from other conventional gas purchase con-

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[12]The Tenneco-Conoco and Union offers of settlement are much worse than the Northwest settlements' treatment of liquids. Under the latter agreements, Phillips and Getty do not share in plant liquids.

tracts between El Paso and Tenneco or Conoco, even though those contracts are entirely separate from the GLA properties at issue here.

Moreover, the Tenneco-Conoco offer of settlement contemplates the construction of a new San Juan Basin cryogenic gas processing plant by Tenneco and Conoco which would strip the GLA gas and the conventional Tenneco-Conoco gas contract volumes of more liquids than are currently removed. As a result, the energy content of the gas available to El Paso's system will fall, decreasing the gas energy supply otherwise available, and increasing the liquids revenues for Tenneco and Conoco.[13] To add insult to injury, El Paso has promised to process sufficient volumes of its own gas at the new plant to ensure that the plant will operate at capacity. Tenneco and Conoco will be entitled to keep 39 percent of the liquids removed from El Paso's gas as a processing fee. This provision of the Tenneco-Conoco offer of settlement would further reduce the gas energy available to El Paso's customers while enriching Tenneco and Conoco.

Furthermore, Tenneco and Conoco have reserved the right to 25 percent of the gas production from wells drilled after 1977, while Union has reserved the right to 25 percent of the gas produced from wells drilled after deliveries commence under the new gas purchase agreement.[14] Petitioners

[13]The Northwest settlements do not contain any comparable provision adversely affecting the Btu content of the gas.

[14]Phillips and Getty in the Northwest settlements did not reserve comparable rights to retain gas. In this respect, the Northwest settlements are more favorable than the Tenneco-Conoco and Union offers of settlement.

are informed that post-1977 wells on the Tenneco and Conoco GLAs produce over half the gas coming from those properties. Consequently the amounts of gas at issue are substantial and gas consumers face a significant reduction in the gas supply available from the San Juan Basin.

The Petitioners do not know the exact value of the liquids and gas volumes at stake under the offers of settlement, but we believe that the potential amounts in question could climb into the billions of dollars. To assess the full impact of the offers of settlement will require much more analysis and discovery. The general effects of the offers' disposition of liquids and gas pricing, however, can only have tremendous long lasting adverse consequences on the price and supply of gas for consumers throughout California, Arizona and Nevada. Under the offers of settlement, even in the short term, gas consumers would pay hundreds of millions of dollars more than they would if the FERC were found to have jurisdiction. Over the longer term, the adverse impacts on consumers would climb much higher.

In this connection, it is interesting to note that Tenneco and Conoco appear willing to implement the offer of settlement even if the GLAs are nonjurisdictional, provided that a satisfactory FERC order accepting the offer of settlement is obtained. Counsel for Tenneco and Conoco has stated that under the *status quo*, their overriding royalties receipts would amount to approximately $6 billion over the next twenty years.[15] For these two companies to be willing to live with the offer of settlement in the event of nonjurisdiction suggests that Tenneco and Conoco will receive at

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[15]Quoted in the *Houston Post*, March 1, 1984, at 1F.

least as much under the offer of settlement as the *status quo* would give them. There is no reason to believe that Tenneco and Conoco will voluntarily forego revenues which are within their grasp. Instead, it appears that through the treatment of liquids and reservations of gas, Tenneco and Conoco are still exacting the same total effective cost for the GLA gas.

The Tenneco-Conoco and Union offers of settlement would also dispose of the refund issue in a manner which underscores the need for this Court to grant the petitions for certiorari. Petitioners believe that the refund liability for GLA holders in this case could amount to as much as $1 billion.[16] If implemented, the Tenneco-Conoco offer of settlement would eliminate any further inquiry into this matter by limiting Tenneco and Conoco's refund obligation to $50 million regardless of whether certiorari is granted or not. The only way the right to litigate the refund claims can be preserved is for this Court to grant the petitions for certiorari and reverse the Fifth Circuit decision. In that event, rejection of the offer of settlement would open the way for the parties to contest the refund issue before the FERC. Similarly, the refund liability of Union can only be pursued if the Court grants certiorari and overturns the Fifth Circuit decision because the Union offer of settlement makes no provision for refunds if the GLAs are not subject to the FERC's jurisdiction. Therefore it is critical to a just resolution of past issues as well as for the future for this Court to grant the petitions for certiorari.

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[16]Tenneco and Conoco's GLAs account for approximately 70% of the El Paso gas at stake. Hence Tenneco and Conoco's potential refund liability could amount to approximately $700 million.

III

THE OFFERS OF SETTLEMENT DO NOT CHANGE THE NEED FOR THIS COURT TO GRANT THE PETITIONS FOR CERTIORARI

The offers of settlement are subject to challenge and hearing before the FERC. If that process is to make a real difference, however, the administrative agency needs jurisdiction over the gas lease holders, as well as the pipeline.[17] The FERC cannot make an informed decision in the public interest on the offers of settlement unless it knows whether or not it has jurisdiction over the GLAs. Consequently, it is extremely important for the Court to grant the petitions for writ of certiorari now and decide the jurisdictional issue so the FERC will know the extent to which it can call Tenneco, Conoco and Union to account.

Petitioners have serious problems with the Tenneco-Conoco and Union offers of settlement. From our perspective, the offers of settlement would have very serious adverse, long term effects on the cost and supply of San Juan Basin gas. If certiorari is granted and the GLAs are held subject to the FERC's jurisdiction, however, the FERC will have the power to resolve this controversy and protect the public interest which is threatened by the Tenneco-Conoco and Union settlement offers.

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[17]The courts have recognized that consumers can only be protected from the price pressures of producer rate increases if the FERC has regulatory authority over the producers. *Consumer Federation of American v. FPC*, 515 F.2d 347 (D.C. Cir.), *cert. denied*, 423 U.S. 906 (1975). By the same token, the FERC needs jurisdiction over all parties, including the GLA holders, to prevent the exploitation that would occur under the offers of settlement.

For these reasons, Petitioners submit that the Tenneco-Conoco and Union offers of settlement do not lessen in any way the need for the Court to grant the petitions for writ of certiorari. As stated in the Solicitor General's reply brief, "The future ramifications of this case alone are themselves sufficiently substantial to warrant certiorari."[18] The offers of settlement do not change that fact.

Respectfully submitted,

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[18]Reply Memorandum for Petitioner Federal Energy Regulatory Commission at 5.

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Respondents.

On Petitions For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

JOINT SUPPLEMENTAL BRIEF OF PETITIONER EL PASO NATURAL GAS COMPANY AND RESPONDENTS TENNECO OIL COMPANY AND CONOCO INC.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

Nos. 83-1321, 83-1432, 83-1433,
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JOINT SUPPLEMENTAL BRIEF OF PETITIONER EL PASO NATURAL GAS COMPANY AND RESPONDENTS TENNECO OIL COMPANY AND CONOCO INC.

El Paso Natural Gas Company ("El Paso"), Petitioner in Cause No. 83-1442 above, and Tenneco Oil Company ("Tenneco Oil") and Conoco Inc. ("Conoco"), Respondents in all of the above-referenced causes, jointly file this Supplemental Brief pursuant to Sup. Ct. R. 22.6, in order to disclose that a comprehensive settlement agreement has been entered into between El Paso and Tenneco Oil and Conoco. On May 18, 1984, an "Offer of Settlement and Joint Request for Approval of Stipulation of Settlement and Agreement" was filed by these parties with the Federal Energy Regulatory Commission ("FERC"). The

settlement agreement reached between El Paso and Tenneco Oil and Conoco, if approved by the FERC and other responsible governmental agencies, constitutes a full and final settlement of all proceedings involving the gas lease agreements covering nearly seventy per cent (70%) of the volumes of gas produced by El Paso that is involved in the cases referenced above.

El Paso, Tenneco Oil and Conoco did not previously inform the Court of the filing of this Offer of Settlement with the FERC because the FERC has not reviewed or acted upon any aspect of the Offer of Settlement. These parties wish to advise the Court of the settlement since it is mentioned in the Reply Memorandum filed by the FERC.

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v.

TENNECO OIL COMPANY, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

SUPPLEMENTAL MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION

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ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

SUPPLEMENTAL MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION

This supplemental memorandum is filed in response to the Court's invitation to the parties to discuss the offer of settlement submitted to the Commission on May 18, 1984, by El Paso, Tenneco Oil Company and Conoco (hereinafter the Tenneco Oil settlement offer), as well as any other agreed—upon settlements that might have a bearing on the instant petitions for a writ of certiorari.

In the discussion that follows, we describe the principal provisions of the Tenneco Oil settlement offer. We also describe the pertinent provisions of two settlements that have been approved by the Commission and of one other pertinent application that is presently being contested in proceedings before the Commission. We emphasize at the

outset that the Commission takes no position at this time on whether the applications that are pending before it are in the public interest.

1. a. The Tenneco Oil settlement offer is the latest of four settlements entered into by parties to this case.[1] Two earlier settlements, one involving Northwest Pipeline and Phillips Petroleum, and the other involving Northwest and Getty Oil, have been approved by the Commission. *El Paso Natural Gas Co.*, 25 F.E.R.C. para. 61,292 (1983); *El Paso Natural Gas Co.*, 26 F.E.R.C. para. 61,421 (1984). The Commission found these two settlement agreements to be substantially identical (*id.* at 61,943). The settlements provide in pertinent part as follows:

> (1) Northwest is to pay Phillips and Getty overriding royalty payments based on the applicable NGPA ceiling prices (the "old" gas replacement contract rate, currently about 86¢ per MMBtu; this rate is subject to possible rollback to the flowing gas rate, currently about 47¢ per MMBtu) less Northwest's cost of production;
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> (2) None of the processing plant liquids are to be credited to the producers, Phillips and Getty; and
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> (3) In the event that the lease sales in question are found jurisdictional by the courts, Northwest would receive refunds back to September 25, 1980, of about $30 million from Phillips and about $2 million from Getty; Northwest would pass through these refunds to its customers.

The Commission emphasized that its approval of these uncontested settlements does not constitute a decision on the merits of any issue. Rather, the Commission reviewed

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[1]We are lodging with the Clerk of the Court copies of the pertinent applications to the Commission arising from these settlements.

the terms of the settlements in light of the court of appeals' decision in this case, and found the settlements to be fair, reasonable and in the public interest. 25 F.E.R.C. at 61,673-61,674.[2] Because these settlements expressly provide that any refunds from the producers to the pipeline (and ultimately to the customers) are contingent on a ruling that the lease sales are jurisdictional, it is clear that these Commission-approved settlements do not render moot the question of Commission jurisdiction presented in the instant petitions.

b. On November 11, 1983, Union Oil Company and El Paso entered into a settlement under which El Paso would reassign to Union the properties involved in the El Paso-Union GLA's. The reassignment is contingent upon Union's receiving a satisfactory certificate of public convenience and necessity from the Commission pursuant to Section 7(c) of the Natural Gas Act, 15 U.S.C. 717f(c), authorizing it to sell gas produced from the subject properties. Thereafter, on December 13, 1983, Union filed with the Commission an application for such a certificate. A number of intervenors, including the Southern California Gas Company, the Pacific Gas and Electric Company and the State of California, objected to the application and requested an evidentiary hearing.

On May 10, 1984, the Commission set the matter for hearing before an administrative law judge.[3] That hearing has not yet commenced. In its order setting the matter for hearing, the Commission stated that, although the El Paso-

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[2]In approving the Northwest-Phillips settlement, the Commission stated (25 F.E.R.C. at 61,674):

> Critical in the balance is the uncertainty of the outcome of further court review of the former Fifth Circuit's decision concerning the Commission's jurisdiction over the GLA's and PLA's.

[3]We are lodging copies of the Commission's order with the Clerk of the Court.

Union settlement had not been submitted to it for approval, it is important for the Commission to ascertain the impact of the settlement on El Paso's customers in order to determine whether to grant Union's requested sales authorization (slip op. 4). The Commission therefore has required Union and El Paso to demonstrate that the settlement is in the public interest (*ibid.*).

The El Paso-Union settlement does not discuss the issue of refunds for past overpayments. Thus, if this Court were to grant certiorari and reverse the judgment of the court of appeals, the refund issue would remain to be addressed in the Commission's remedy proceeding, which was suspended after the court of appeals found the transactions nonjurisdictional.

The prospective effect of the El Paso-Union settlement may be summarized as follows:

(1) El Paso will reassign the properties to Union, which will sell the gas to El Paso under a conventional contract;

(2) Union will reserve for itself 25% of the gas it produces from newly drilled wells;

(3) Union's share of the net interest liquids under its properties will increase from 33-1/3% to 77% (and ultimately to 100% if Union elects to have the gas processed by a party other than El Paso);

(4) Union will charge El Paso several different prices for the gas, including the Section 109 rate for "old" gas (about $2.40 per MMBtu), on the theory that that gas was committed or dedicated to interstate commerce prior to enactment of the NGPA but was not subject to a just and reasonable rate set by the Commission;

(5) Union has the right to adopt the terms of any agreement entered into by El Paso with Tenneco Oil or Conoco.

The settlement also provided that Union could withdraw from the settlement if the Commission did not grant authorization for the sale of gas from Union to El Paso by April 1, 1984. Because the Commission has not yet granted such authorization, Union is free to withdraw from the settlement at any time.

c. The Tenneco Oil settlement offer was filed with the Commission on May 18, 1984. This settlement provides, in pertinent part, as follows:

(1) El Paso will reassign all of its GLA properties to Tenneco Oil and Conoco, which will sell the gas back to El Paso under conventional contracts;

(2) Tenneco Oil and Conoco will reserve for themselves 25% of the gas produced from post-1977 wells (about 50% of the gas comes from such wells);

(3) Tenneco Oil and Conoco will construct a new processing plant to extract more of the liquids from the gas stream (when the plant is completed, Tenneco Oil and Conoco will retain 100% of the liquids; until then, they will receive 77% of the liquids);

(4) Tenneco Oil and Conoco will sell the gas to El Paso at the applicable NGPA prices, except that "old" gas will be priced at $2.00 per MMBtu (plus NGPA monthly escalations) until July 1986, when it will be rolled back to the NGPA Section 106(a) rate (now about 88¢ per MMBtu);

(5) Tenneco Oil and Conoco will pay El Paso $50 million in refunds regardless of the outcome of the present litigation;

(6) The parties will amend a number of gas purchase contracts in the San Juan Basin to give the liquid rights to Tenneco Oil and Conoco; and

(7) Tenneco Oil and Conoco can withdraw from the settlement if it is not approved by August 1985 or within six months of a denial of certiorari; El Paso can withdraw from the settlement if it is not approved by August 1985 or within 30 days of a decision by this Court reversing the judgment of the court of appeals.

Because the ability of the parties to withdraw from the settlement is contingent upon this Court's disposition of the case, it seems clear that the mere filing of the offer of settlement with the Commission does not moot the jurisdictional issue presented in the instant petitions.

2. The procedures governing offers of settlement submitted to the Commission are set forth in Rule 602 of the Commission's Rules of Practice and Procedure, 18 C.F.R. 385.602.[4] Under this rule, uncontested offers of settlement, such as the Phillips and Getty settlements with Northwest, may be approved "upon a finding that the settlement appears to be fair and reasonable and in the public interest" (18 C.F.R. 385.602(g)(3)). Where an offer of settlement is contested, the Commission may decide the merits of the settlement "if the record contains substantial evidence upon which to base a reasoned decision or the Commission determines there is no genuine issue of material fact" (18 C.F.R. 385.602(h)).

Although, as discussed above, the Union settlement was submitted to the Commission in the form of an application by Union to sell the gas reassigned to it back to El Paso rather than in the form of an offer of settlement, it is evident from the Commission's order setting the matter for hearing

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[4]This rule is set forth at App., *infra*, 1a-5a.

that the Commission is treating Union's application as it would a contested settlement. The Tenneco Oil settlement offer was filed with the Commission on May 18, 1984, and comments thereon are not due until July 2, 1984. At this juncture, the Commission obviously is in no position to express any views concerning the merits of either settlement.[5]

Instead, we would note only that the Union and Tenneco Oil settlement offers are presently at early procedural stages before the Commission. It is likely that the Commission will not pass on the propriety of the settlements for a considerable period of time. In addition, if the Commission were to approve a contested settlement, its decision would be subject to judicial review by any aggrieved party.

3. In sum, the Commission's approval of certain settlements on the Northwest system has neither mooted the current litigation with respect to those parties nor made the case less worthy of this Court's consideration. Moreover, the settlements entered into by El Paso and three of the producers are subject to challenge by El Paso's customers, are likely to be pending before the Commission for some time, and if approved by the Commission would still be subject to judicial review. Accordingly, we adhere to the view expressed in our petition and reply memorandum that the overall ramifications of this case are sufficiently substantial to warrant review.

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[5]It would be particularly inappropriate for the Commission to comment on the merits of the settlement offers in light of the objections that have already been filed to Union's settlement, and in light of the recent submissions filed with this Court by the State of California, Pacific Gas and Electric and Northwest, which indicate that the Tenneco Oil settlement will most probably be contested.

It is therefore respectfully submitted that the petitions for a writ of certiorari should be granted.

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APPENDIX

§ 385.602 Submission of settlement offers (Rule 602).

(a) *Applicability.* This section applies to written offers of settlement filed in any proceeding pending before the Commission or set for hearing under Subpart E. For purposes of this section, the term "offer of settlement" includes any written proposal to modify an offer of settlement.

(b) *Submission of offer.* (1) Any participant in a proceeding may submit an offer of settlement at any time.

(2) An offer of settlement must be filed with the Secretary. The Secretary will transmit the offer to:

(i) The presiding officer, if the offer is filed after a hearing has been ordered under Subpart E of this part and before the presiding officer certifies the record to the Commission; or

(ii) The Commission.

(c) *Contents of offer.* (1) An offer of settlement must include:

(i) The settlement offer;

(ii) A separate explanatory statement;

(iii) Copies of, or references to, any document, testimony, or exhibit, including record citations if there is a record, and any other matters that the offerer considers relevant to the offer of settlement; and

(iv) A separate proposed Commission order approving the settlement, including the following statement: "The Commission's approval of this settlement does not constitute approval of, or precedent regarding, any principle or issue in this proceeding".

(2) If an offer of settlement pertains to a tariff or rate filing, the offer must include any proposed change in a form suitable for inclusion in the filed rate schedules or tariffs, and a number of copies sufficient to satisfy the filing requirements applicable to tariff or rate filings of the type at issue in the proceeding.

(d) *Service.* (1) A participant offering settlement under this section must serve a copy of the offer of settlement:

(i) On every participant in accordance with Rule 2010.

(ii) On any person required by the Commission's rules to be served with the pleading or tariff or rate schedule filing, with respect to which the proceeding was initiated.

(2) The participant serving the offer of settlement must notify any person or participant served under paragraph (d)(1) of this section of the date on which comments on the settlement are due under paragraph (f) of this section.

(e) *Use of non-approved offers of settlement as evidence.* An offer of settlement that is not approved by the Commission, and any comment on that offer, is not admissible in evidence against any participant who objects to its admission.

(2) Any discussion of the parties with respect to an offer of settlement that is not approved by the Commission is not subject to discovery or admissible in evidence.

(f) *Comments.* (1) A comment on an offer of settlement must be filed with the Secretary who will transmit the comment to the Commission, if the offer of settlement was transmitted to the Commission, or to the presiding officer in any other case.

(2) A comment on an offer of settlement may be filed not later than 20 days after the filing of the offer of settlement and reply comments may be filed not later than 30 days after

the filing of the offer, unless otherwise provided by the Commission or the presiding officer.

(3) Any failure to file a comment constitutes a waiver of all objections to the offer of settlement.

(g) *Uncontested offers of settlement.* (1) If comments on an offer are transmitted to the presiding officer and the presiding officer finds that the offer is not contested by any participant, the presiding officer will certify to the Commission the offer of settlement, a statement that the offer of settlement is uncontested, and any hearing record or pleadings which relate to the offer of settlement.

(2) If comments on an offer of settlement are transmitted to the Commission, the Commission will determine whether the offer is uncontested.

(3) An uncontested offer of settlement may be approved by the Commission upon a finding that the settlement appears to be fair and reasonable and in the public interest.

(h) *Contested offers of settlement.* (1)(i) If the Commission determines that any offer of settlement is contested in whole or in part, by any party, the Commission may decide the merits of the contested settlement issues, if the record contains substantial evidence upon which to base a reasoned decision or the Commission determines there is no genuine issue of material fact.

(ii) If the Commission finds that the record lacks substantial evidence or that the contested issues can not be severed from the offer of settlement, the Commission will:

(A) Establish procedures for the purpose of receiving additional evidence before a presiding officer upon which a decision on the contested issues may reasonably be based; or

(B) Take other action which the Commission determines to be appropriate.

(iii) If contested issues are severable, the uncontested portions may be severed and decided in accordance with paragraph (g) of this section.

(2)(i) If any comment on an offer of settlement is transmitted to the presiding officer and the presiding officer determines that the offer is contested, in whole or in part, by any participant, the presiding officer may certify all or part of the offer to the Commission. If any offer or part of an offer is contested by a party, the offer may be certified to the Commission only if paragraph (h)(2)(ii) or (iii) of this section applies.

(ii) Any offer of settlement or part of any offer may be certified to the Commission if the presiding officer determines that there is no genuine issue of material fact. Any certification by the presiding officer must contain the determination that there is no genuine issue of material fact and any hearing record or pleadings which relate to the offer or part of the offer being certified.

(iii) Any offer of settlement or part of any offer may be certified to the Commission, if:

(A) The parties concur on a motion for omission of the initial decision as provided in Rule 710;

(B) The presiding officer determines that the record contains substantial evidence from which the Commission may reach a reasoned decision on the merits of the contested issues; and

(C) The parties have an opportunity to avail themselves of their rights with respect to the presentation of evidence and cross-examination of opposing witnesses.

(iv) If any contested issues are severable, the uncontested portions of the settlement may be certified immediately by the presiding officer to the Commission for decision, as provided in paragraph (g) of this section.

(i) *Reservation of rights.* Any procedural right that a participant has in the absence of an offer of settlement is not affected by Commission disapproval, or approval subject to condition, of the uncontested portion of the offer of settlement.